"Bezeq" The Israel Telecommunication Corp. Limited

Periodic Report for 2005

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The information contained in this annual report constitutes a translation of the annual report published by the Company. The Hebrew version was submitted by the Company to the relevant authorities pursuant to Israeli law, and represents the binding version and the only one having legal effect. This translation was prepared for convenience purposes only

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1. Description of General Development of Group Operations

Bezeq The Israel Telecommunication Corp., Ltd. (hereinafter, “the Company” or “Bezeq”) along with the subsidiaries (including partnerships) that it owns in whole or in part, whose financial statements are consolidated with the Company's, shall be jointly referred to in this periodic report as “the Group” or “the Bezeq Group”.

1.1 Group Activity and Description of its Business Development

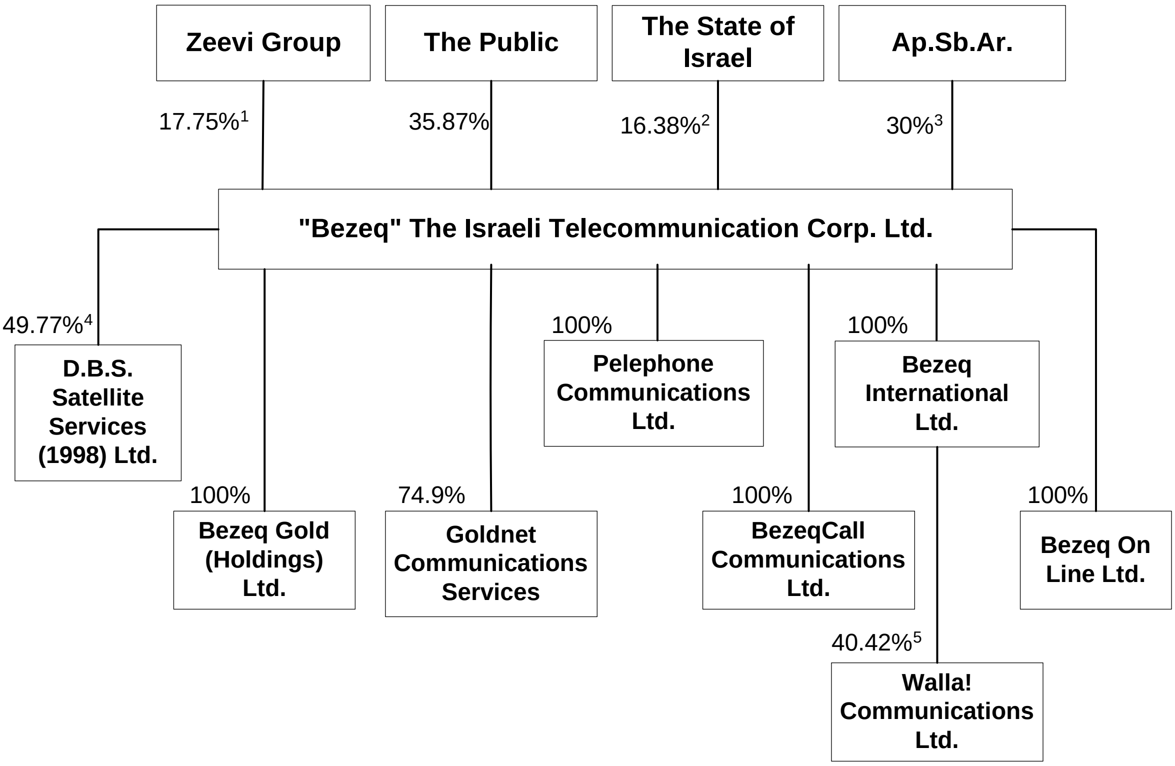
1.1.1 As of the date of this periodic report, The Bezeq Group is the principal provider of communications services in the State of Israel. The Bezeq Group implements and provides a broad range of telecommunications operations and services, including fixed-line domestic services, cellular services, international communications services, transmission to the public of satellite multi-channel television broadcasts, internet access services, customer call centers, maintenance and development of communications infrastructures, provision of communications services to other communications providers, satellite services, transmission to the public of television and radio broadcasts, provision of services and maintenance of equipment on customer premises (network end point services).

1.1.2 Both in the global markets and in Israel, the pace of development in the telecommunications sector is rapid. The telecommunications arena is affected by changes in technology, in relation to both the business structure of the industry and the applicable regulations.

1.1.3 The Company was founded as a government company in 1980 and has been privatized over a period of years. The Company is a public company, the shares in which are traded on the Tel Aviv Stock Exchange.

1.1.4 Following completion of the sale of 30% of the State’s holdings in the Company to Ap.Sb.Ar. Holdings Ltd. (“**Ap.Sb.Ar.** ”) on October 11, 2005, Ap.Sb.Ar. holds 30% of the shares in the Company, as well as an option to purchase up to 10.66% of the shares in the Company that are held by the State.

The diagram below outlines the holdings in the Company and the holdings of the Company in its subsidiaries and principal affiliated companies, as of the date of the periodic report:



1.1.5 Mergers and Acquisitions

DBS Satellite Services (1998) Ltd. (hereinafter: "**DBS**")

On January 2, 2005, the Antitrust Commissioner conditionally approved the merger between the Company and DBS (increase of the Company's holdings in DBS to more than 50%). A year after the approval, the grant of the approval of the merger expired and requires a new consent.

For a detailed description of the developments in this area, see Note 8E to the Company's financial statements for the year ending December 31, 2005, included in this periodic report.

1.1.6 Sales

Intelsat Satellite Corporation (hereinafter: "**Intelsat**")

The Company held 0.7405% of Intelsat shares. Additionally, the Company held approximately 0.8% of New Skies Satellites N.V. (hereinafter: "NSS"), a subsidiary that was "spun off" from the aforementioned corporation. These holdings were sold for a total consideration of approximately 31 million dollars.

As a result of this, the Company recorded a capital gain in the full amount of the consideration which was received, in the sum of approximately NIS 139 million (of

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[1] Of this, 17.63% are held by Zeevi Communications Holdings Ltd., to which a receiver has been appointed, with authority to exercise the rights flowing from the shares in accordance with the ruling and approval of the Court.

[2] For the option granted to Ap. Sab. Ar. to purchase up to approximately 10.66% of the State's shares, see section 1.3 below; for employee options, see section 2.9 below.

[3] The shareholders in Ap. Sab. Ar. are: 1. SCG Israel Ventures LLC (capital 45%, voting 40.5%) which is controlled by private companies controlled by Haim Saban. 2. Purple Green Project and Investment Co. Ltd. together with Yellow Green Financing and Investment Ltd. (jointly: capital 45%, voting 40.5%), indirectly wholly owned (100%) by corporations in the Apax Europe VI Fund, managed by Apax Europe Managers Ltd. 3. Arkin Communications Ltd. (capital 10%, voting 19%), which is wholly owned (100%) by Moshe Arkin.

[4] The Company has option warrants (and/or is entitled to receive option warrants) as at the date of publication of this periodic report, to increase its holdings of DBS to approximately 58.36% pro rata its investments.

[5] At full dilution 33.66%

which, NIS 35 million was in 2004 and NIS 104 million was in 2005). The taxes applied to these capital gains will be at the tax rates commonly applied to capital gains in Israel.

In this regard, see Note 9C to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

Satellite Communications Operations

On February 14, 2006, the Company signed a memorandum of understanding (MOU) with a foreign investor regarding the sale of the Company's satellite communications operations (Inmarsat and BezeqSat) and assets related to such operations, in consideration for nine million US dollars.

Completion of the transaction is contingent upon execution of a final agreement between the parties, and upon consents and approvals, bother internal and external, including by the competent organs of the parties, of the Ministry of Defense, the Ministry of Communications and the Antitrust Commissioner.

If the transaction is completed, the Company is expected to record a capital gain in respect of it of approximately NIS 30 million (before tax).

In this regard, see Note 9F to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

1.2 Areas of Activity

The Group is engaged in four main areas of activity as well as a "miscellaneous" area of activity that includes all other Group activities. These five areas of activity are reported as business segments in the Company's consolidated financial statements (see also Note 26 to the Company's financial statements for the year ended December 31, 2005, included in this periodic report).

1.2.1 Fixed-line domestic communications

This segment primarily includes telephony services, internet access services, transmission services and data communications. This activity is performed by the Company.

1.2.2 Cellular services

Cellular mobile radio-telephone services (cellular communications), marketing of end-user equipment, installation, operation and maintenance of cellular communications equipment and systems. This activity is performed by Pelephone Communications Ltd. (hereinafter: "**Pelephone**").

1.2.3 International communications and internet services

International communications services as well as internet access services (ISP). This activity is performed by Bezeq International Ltd. (hereinafter: "**Bezeq International**").

1.2.4 Multi-channel television

Multi-channel digital television broadcasts to subscribers over satellite (DBS) and provision of value-added services to subscribers. This activity is performed by DBS Satellite Services (1998) Ltd. (hereinafter: "**DBS**").

1.2.5 Others

This segment comprises three sub-segments, each of which alone, and the three combined together do not constitute a major component of the Group. They are as follows:

A. BezeqCall Communications Ltd. (hereinafter: "**BezeqCall**")

Network end point services (installation, maintenance and operation of a private network, private exchanges and other communications devices at subscriber premises, including multi-line private switchboards and with the exception of home network end point services) as well as marketing and distribution of terminal equipment and private exchanges. Total revenues from this sub-segment in 2005 amounted to approximately NIS 249 million.

B. Bezeq On Line Ltd. (hereinafter: "**Bezeq On Line**")

Customer call center services in a variety of areas. Total revenues from this sub-segment in 2005 amounted to approximately NIS 55 million.

C. Goldnet Communications Services Partnership (hereinafter: "**Goldnet**")

Content services to the business sector, operation of electronic communities and other services. Total revenues from this sub-segment in 2005 amounted to approximately NIS 32 million.

The activity of each of the above sub-segments in the reported year was balanced (approximately) in operating terms.

1.3 Investments in Equity and Stock Transactions

1.3.1 On June 1, 2004, via the Company's prospectus of May 24, 2004, the State of Israel offered 156,000,000 ordinary shares of NIS 1 par value each of the Company, (approximately 5.99% of the Company's issued capital). The result of the offer of sale to the public was the sale of 70,671,100 shares of NIS 1 par value each (approximately 2.71% of the issued capital of the Company), at a price of NIS 4.921 per share.

1.3.2 In 2005, the State of Israel completed the process of sale of the core of its control of the Company, pursuant to the decision of the Ministerial Committee on Privatization, dated July 19, 2004, to the effect that the State's holdings of the Company would be sold by way of private sale of 30% of the share capital of the Company and the grant of options to purchase a further 10.66% of the share capital of the Company.

The State chose Ap.Sb.Ar., which offered NIS 4,237,000,000 for 30% of the share capital of the Company (781,513,683 shares) and an option to purchase an additional 10.66% of the shares of the Company (277,697,862 shares) as preferred offeror. Transfer of the State's holdings to Ap.Sb.Ar. required the receipt of consents under all laws, including the consent of the Prime Minister and the Minister of Communications, under the Communications (Telecommunications and Broadcasts) Law, 5742-1982 (the "**Communications Law**") and the Communications (Prescription of Essential Service Provided by Bezeq – the Israel Telecommunications Corp. Ltd.) Order, 5757-1997 (the "**Communications Order**"), and the consent of the Antitrust Commissioner under the Antitrust Law, 5748-1988.

Following the "industrial espionage" incident (see in this regard section 2.20.3 below) and disputes that have arisen between the State and Ap.Sb.Ar. regarding the effect of that incident on the Bezeq Group, on July 7, 2005, the Parties reached an agreement regarding various demands made by Ap.Sb.Ar. as conditions of completion of the transaction. Based on a notice from the Government Companies Authority, this agreement has implications on the exercise price of the options received by Ap.Sb.Ar., to the extent that such might relate to and result from the above incident, plus the accrual of interest on the transaction price up to completion of it. For this matter, see the Company's Immediate Reports dated July 10, 2005 and July 14, 2005.

On October 11, 2005 (after obtaining all of the consents required under the law), the aforesaid transaction was completed under the conditions set out in the agreement for sale of the State's holdings in the Company between the State of Israel and Ap.Sb.Ar. (and the holders of interests therein) of such date.

In consideration for the shares and options as aforesaid, the total sum of NIS 4,246,286,575 was paid by Ap.Sb.Ar.

Ap.Sb.Ar.'s shares in the Company are held in trust by Romema Investment Company Ltd.

According to information provided to the Company:

A. Pursuant to the agreement with the State, Ap.Sb.Ar. purchased 30% of the State's shares in the Company and an option for the purchase of up to 277,697,862 of the State's shares in the Company (constituting approximately 10.66% of the share capital of the Company), on the conditions set out in the above agreement, as set out in the Company's immediate reports dated July 14, 2005 and October 16,

2005. The option is exercisable up until the first day of business 48 months after October 11, 2005 (the date of completion of purchase of the Company's shares).

B. Pursuant to this agreement, Ap.Sb.Ar. shall be entitled to request that the State vote together with it (under the limitations set out in the agreement regarding certain matters) in respect of the 10.66% of the shares in the Company held by the State in respect of which Ap.Sb.Ar. has an option to purchase, and in respect of the 1.01% that will remain in the State's possession during the period commencing on October 11, 2005 (the date of completion of the transaction) and ending at the end of the option exercise period, and in respect of the 4.71% of the Company's shares held by the State and designated for allotment to employees of the Company (see Section 2.9.6 below) – for such period or until transfer of title to such shares to the Company's employees, whichever is the earlier.

As a result of completion of the transaction, the Company has been released from certain limitations that had been imposed upon it as a company under the control of the State of Israel, including repealed and/or amendment of part of the provisions of its articles of association, which are similar to certain provisions of the Government Companies Law, 5735-1975. Likewise, the articles of association of the wholly owned subsidiaries of the Company were also amended, such that, *inter alia*, provisions regarding the number of members of the board of directors and the proceedings of appointment of them, and the composition of committees of the board of directors were amended, and provisions relating to the Government Companies Law (contained in the articles of association of former government subsidiaries) were repealed. Further to such, the directors of the Company's subsidiaries were replaced such that directors were appointed from the ranks of senior management of the Group, subject to the rules of structural separation in the Group.

1.4 Distribution of Dividends

1.4.1 In 2004 and 2005, the Company did not distribute a dividend to its shareholders.

1.4.2 Pursuant to a resolution of the board of directors of March 1, 2006, resolutions regarding the distribution of dividends are to be passed specifically with respect to the Company's financial results, its financial status and other relevant circumstances and data. This resolution replaces previous resolutions regarding dividend policy.

1.4.3 On March 1, 2006, the board of directors of the Company resolved to recommend to the general meeting of shareholders of the Company to distribute a cash dividend to the shareholders of the Company, in the total sum of NIS 1,200,000,193, constituting, as at the date of the distribution, NIS 0.4606446 per share, and 46.06446% of the issued and paid-up share capital of the Company. Under the resolution, the rate of the dividend to actually be paid will be set in accordance with the issued and paid-up share capital of the Company at the end of business on April 2, 2006 (the "Effective Date"). The dividend shall be paid to those shareholders of the Company who are listed on the register of shareholders of the Company at the end of the Effective Date. The "ex" date shall be April 3, 2006 and the payment date shall be April 16, 2006. Withholding tax is to be deducted from this dividend in accordance with the provisions of the law.

A special general meeting of shareholders of the Company on the agenda of which is to be approval of distribution of the dividend to the shareholders of the Company as aforesaid has been convened for March 23, 2006.

1.4.4 It should be noted that a procedure issued by the Government Companies Authority for the sale of the core control in the Company stipulated that the sales agreement signed by the party purchasing the core control shall undertake, *inter alia*, to act in accordance with his holdings such that no division of the balance of accrued profits of the Company as at December 31, 2000, will be made (the procedure clarifies that this shall not prevent the distribution of accrued profits subsequent to December 31, 2000, under the Companies Law, 5759-1999). The purchaser of the core control shall also undertake to act in accordance with his holdings such that there will be no division of capital gains resulting from the disposal of capital assets the consideration for which was paid in kind shall be effected for a period of two years from the date of acquisition of the shares sold.

Further to such, it was clarified to the participants in the privatization proceeding by the Director General of the Government Companies Authority, in a letter dated April 19, 2005, that the position of the Government Companies Authority is that no restrictions will be imposed on the purchase of the core control preventing him from initiating and implementing a distribution with the approval of a court in accordance with Section 303 of the Companies Law, 5759-1999 (reduction of capital). In addition, the Company received a copy of a letter which was sent to the Director General of the Government Companies Authority on April 17, 2005 by the Chairman of the Company Workers Organization, in which the Chairman of the organization informs that participants that the Company Workers Organization sees a distribution pursuant to Section 303 of the Companies Law as contrary to the arrangements with the Company employees and that any attempt to reduce the capital will meet the strong opposition of the employees. However, a document of principles executed between Ap.Sb.Ar. and the Workers Organization prior to transfer of control from the State to Ap.Sb.Ar. (see Section 2.9.5 below), contained reference to the issue of reduction of capital and agreement might be reached with the Workers Organization in this regard.

1.5 Financial Information on the Group's Areas of Activity

1.5.1 <u>2005:</u>

	Domestic fixed-line communication	Cellular	International communication and internet services	Multi-channel television	Others	Adjustments to consolidated*	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Total revenues:							
From externals	4,457,189	4,413,421	795,176	1,200,865	232,035	–	11,098,686
From other areas of operation in the segment	266,545	14,854	21,488	20,997	104,511	(428,395)	-
Total	4,723,734	4,428,275	816,664	1,221,862	336,546	(428,395)	11,098,686
Total attributed costs:							
Costs not constituting revenues in another area of operation	3,811,200	3,779,328	641,192	1,224,599	325,289	–	9,781,608
Costs constituting revenues from other areas of operation	61,261	182,782	77,494	96,798	10,060	(428,395)	-
Total	3,872,461	3,962,110	718,686	1,321,397	335,349	(428,395)	9,781,608
Operating income	851,273	466,165	97,978	(99,535)	1,197		1,317,078
Total identified assets as at December 31, 2004	8,217,243	4,834,849	683,068	1,348,813	254,166	(185,581)	15,152,558
Minority percentage in the segment					25.1% (GoldNet)		

* Details of the nature of the adjustments to the consolidated – inter-company transactions between areas of activity.

1.5.2 2004:

	Domestic fixed-line communication	Cellular	International communication and internet services	Multi-channel television	Others	Adjustments to consolidated*	Consolidated
	NIS thousands	**NIS thousands**	**NIS thousands**	**NIS thousands**	**NIS thousands**	**NIS thousands**	**NIS thousands**
Total revenues:							
From externals	4,736,756	2,966,486	797,735	529,838	238,989	–	9,269,804
From other areas of operation in the segment	222,935	8,493	18,704	12,304	80,387	(342,823)	–
Total	4,959,691	2,974,979	816,439	542,142	319,376	(342,823)	9,269,804
Total attributed costs:							
Costs not constituting revenues in another area of operation	3,933,351	2,450,650	612,217	597,602	284,436	–	7,878,256
Costs constituting revenues from other areas of operation	55,324	145,001	85,999	29,921	26,578	(342,823)	–
Total	3,988,675	2,595,651	698,216	627,523	311,014	(342,823)	7,878,256
Operating income	971,016	379,328	118,223	(85,381)	8,362	–	1,391,548
Total identified assets as at December 31, 2004	8,589,680	4,775,659	598,090	1,364,941	235,240	(206,476)	15,357,134
Minority percentage in the segment					25.1% (GoldNet)		

* Details of the nature of the adjustments to the consolidated – inter-company transactions between areas of activity.

1.5.3 2003

	Domestic fixed-line communication	Cellular	International communication and Internet services	Multi-channel television*	Others	Adjustments to consolidated**	Consolidated
	NIS thousands	**NIS thousands**	**NIS thousands**	**NIS thousands**	**NIS thousands**	**NIS thousands**	**NIS thousands**
Total revenues:							
From externals	5,023,754	2,021,807	689,378	–	246,329	–	7,981,268
From other areas of operation in the segment	206,807	5,568	13,958	–	40,236	(266,569)	–
Total	5,230,561	2,027,375	703,336	–	286,565	(266,569)	7,981,268
Total allocated costs:							
Costs not constituting revenues in another area of operation	4,274,937	1,807,638	531,702	–	273,642	–	6,887,919
Costs constituting revenues from other areas of operation	49,005	123,724	81,633	–	12,851	(267,213)	–
Total	4,323,942	1,931,362	613,335	–	286,493	(267,213)	6,887,919
Operating income	906,619	96,013	90,001	–	72	644	1,093,349
Total identified assets as at December 31, 2003	9,903,468	2,258,000	527,565	–	213,574	(106,196)	12,796,411
Minority percentage in the segment					25.1% Goldnet		

* Not consolidated in the financial statements.

** Details of the nature of the adjustments to the consolidated – inter-company transactions between areas of activity.

1.6 General Environment and Effect of External Factors on Group Activity

The Group's business is affected by the level of the financial activity in the domestic market and therefore, positive or negative developments at this level are expected to have a corresponding impact on the business of the Group. Thus, for example, growth in the GNP and in the number of people employed in the market is expected to impact positively on Group revenues.

The Israeli communications market is characterized by a high level of concentration and a complex structure of cross-ownerships which are a fertile ground for the setting up of a number of communications groups operating on the basis of marketing cooperation between a number of companies and/or joint holdings for the supply of inclusive communications services, whilst exhausting the marketing and operating advantages that such a structure permits. Given the regulatory limitations imposed upon the group in the context of generation of cooperation between all of the members of the Group, the Group will have difficulty providing appropriate responses to threats stemming from this sort of competitive structure.

2. Fixed-Line Domestic Communications – “Bezeq” – The Israel Telecommunications Corp. Limited (“the Company”)

2.1 General Information Regarding the Area of Operations

2.1.1 Area of activity and changes affecting it

The Company has a general license for the provision of fixed-line domestic communications services. Under this license, the Company provides telephony services, dial-up internet access and associated services; broadband internet access (ADSL); remote access; information services and data communications; transmission services; IP-VPN services; maintenance and development of infrastructures; internet access services between users and ISPs; and other activities, including sale of terminal equipment, satellite and video services, setting up and operation of radio and television broadcasting installations and services for external organizations (billing and collection services, deployment and maintenance of television cables, performance of engineering work, etc). In addition, the Company provides infrastructure and other services to other communications providers. Both in the global markets and in Israel, the pace of development in the telecommunications sector is rapid. The telecommunications arena is affected by changes in technology, in relation to both the business structure of the industry and the applicable regulations.

2.1.2 Legislative and regulatory restrictions and special constraints

The Company’s activity is subject to comprehensive regulation and control that relates, *inter alia*, to matters such as determining and approving the fields of the Company's permitted activity and services, holding and transferring of means of control, licensing, determining tariffs, quality and terms of service to subscribers and obligation to pay royalties. These regulations and controls are attributable to the following: the status of the Company as a licensee, according to the Communications (Telecommunications and Broadcasting) Law, 5742-1982 (hereinafter: the “Communications Law”), and are subject to the provisions of the Communications Law, as well as the regulations and rules that have been promulgated there under, and the terms of its general license. The Company's status as an essential telecommunications service provider is subject to the provisions of the Communications Order based on section 4D of the Communications Law; and other laws.

The tariffs for the Company’s main activities are subject to strict regulation under various provisions of the law. The tariffs are updated and change from time to time in regulations, *inter alia*, according to recommendations of the Committee for the Regulation of Bezeq’s Tariffs. Recently, on June 1, 2005, the tariffs were amended. The interconnectivity tariffs were reduced as of September 1, 2005, and as of November 1, 2005, some of the Company’s tariffs were amended in order to retain “rounded” tariffs, following the reduction of the VAT rate. For these updates, see section 2.16.1. (For a description of the updating mechanism, see Note 1E(1)A to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report).

The Company was declared a monopoly in certain fields of activity, and is similarly subject to control and restrictions under the Antitrust Law, 5748-1988.

Furthermore, some of the Company's activity involves the use of wireless frequencies and operation devices emitting electromagnetic radiation, which are respectively subject to the Wireless Ordinance (New Version), 5732-1972 (see Section 2.16.8 below), the Pharmacists Regulations (Radioactive Elements and their Products), 5740-1980 and the Non-Ionized Radiation Law, 5766-2005 (see Section 2.15 below).

With regard to this Section, see also Section 2.16 below.

2.1.3 Changes in the volume and profitability of the activity

	2005	2004	2003	
Revenues (NIS millions)	4,724	4,960	5,230	
Operating income	851	971	907	
Average monthly revenue per line (NIS) (ARPL)(1)	102	107	111	
Number of active subscriber lines as at the end of the year (thousands)	2,857	2,897	2,914	
Total minutes of use in Israel (incoming outgoing) (millions)	21,485(2)	23,278(2)	28,837	

(1) Not including revenues from transmission and data communications services, services to communications providers, contractor work and other.

(2) Most of the decline in minutes is attributable to lower use of dial-up internet access and the switch to high speed internet services through ADSL technology or cable modem. Additionally, there is a more moderate yet steady decline in minutes as the result of competition with other communications providers (particularly cellular operators).

2.1.4 Developments in the market and in customer attributes

In recent years we have seen growing competition between fixed-line and cellular telephony. If in the past almost all calls were made between two fixed lines, today, more than two thirds of voice calls in the market start or end on cellular networks. As the number of cellular subscribers has grown and reached approximately 7.8 million subscribers (according to data published by the cellular companies), there has been a decline in the number of households and businesses holding a fixed line, as well as a decline in the number of lines per customer. Furthermore, there has been an ongoing average decline in the Company's regulated and unregulated tariffs (see Section 2.16.1 below). For developments in competition in the various domestic fields, see Section 2.6.

2.1.5 Technological changes that significantly impact on the area of activity

A. Penetration of high speed internet and the availability of new IP-based technologies offer consumers a wide variety of applications and services over IP-based infrastructures, such as voice services, video transmission services and network services with organizational applications over the internet infrastructure (ERP, CRM, etc.).

The Company estimates that in the coming years the trend of increased bandwidth to the customer home or business will intensify. This will facilitate penetration of applications required for the transmission of a high volume of data at a fast rate as well as voice services that will enable regular phone calls over the Internet and/or IP networks. Regarding competition through the provision of telephony over the Company's broadband network, see Section 2.6.1 below. Given this trend, the Company needs to adapt its infrastructures so that it will be able to provide its customers with significant bandwidth that will guarantee availability and quality of service.

The development of standardization in this area makes it possible to use the infrastructure owned by the Company which is currently in place in order to provide higher quality telephony services than in the past as an alternative to the telephone line services that the Company suppliers to its customers.

B. Furthermore, there are a wide range of technologies that enable cellular service providers to compete with the Company's services more efficiently than with existing technologies.

C. In addition, wireless technology is being developed which opens the gateways for providing services that compete with the Company's services, in the area of voice calls as well as data communications and broadband internet, without the need to invest heavily in land-based access infrastructure.

D. Technological developments may enable other operators to build infrastructures that provide services similar to those offered by the Company at lower cost. Furthermore, as a result of the advances in technology on the one hand, and the aging technology implemented in the Company's systems, which may be difficult for suppliers to support, on the other hand, it may be necessary to switch to other technologies or increase the maintenance costs of the existing systems.

2.1.6 <u>Critical success factors in the area of operations and changes therein</u>

A. The ability to offer reliable communications systems at a competitive price based on a cost structure that is adjusted to the frequent changes in the Company's business environment.

B. The ability to maintain innovation and technological leadership, and to translate those into advanced, reliable applications of value to customers, within short response times.

C. Technological and marketing innovation.

D. Efficacy of internal and external sales systems and distribution channels.

E. The ability to provide high quality commercial and technical service to customers of the Company.

F. Management of an intelligent price policy, subject to regulatory limitations, in light of growing competition and technological changes that are expressed in generally lower prices in the industry.

G. Intelligent migration of customers from traditional networks to next-generation networks.

2.1.7 <u>Main entry and exit barriers of the activity and changes affecting such</u>

The main entry barrier in the domestic fixed-line communications market is attributable to the need for substantial investments in technological infrastructure and complementary systems until economies of scale are achieved, and from the high costs involved in establishing marketing, sales and customer support systems. In recent years the traditional entry barriers to the Company's areas of activity have been to a great extent removed, as a result of the following factors: Technological improvements, a decline in prices of infrastructure and equipment; easing of regulatory restrictions for new competitors, and in particular – the cancellation of the universal service obligation for select general license holders as well as leveraging of existing systems of communications operators that are competing or are planning on competing against the Company.

The main exit barriers are attributable to the following: the obligation of the Company, as stipulated in its license, to provide services at a defined quality of service on a universal basis; its being subject to the emergency regulations and the provisions of the Communications Order based on section 4D of the Communications Law; its obligation to some of its employees as part of collective bargaining agreements; long-term agreements with infrastructure providers; large investments requiring a long time to ROI; and an obligation to repay long-term loans taken to finance the investments.

2.1.8 <u>Alternatives to and changes in sectoral products</u>

In recent years cellular communications services have to a large extent become an alternative to services offered by the Company, both in the area of telephony and in the area of data communications.

Recently we have seen a growing trend of transmission of voice calls over the internet or over public and private IP-based networks, using dedicated software that is provided free of charge or at a discounted price by companies in Israel and abroad. Furthermore, the internet enables e-mail applications and instant messaging, which to a certain extent are also alternatives to telephone calls. Recently, international software and internet companies have redoubled their efforts to integrate telephony services as part of the service packages that they provide to their customers.

In the area of transmission and data communications services, technological advances enable the provision of new services at high transmission rates and low prices.

2.1.9 Structure of competition in the areas of operation and changes therein

Fixed-line domestic services primarily include telephony services, internet access services, transmission services and data communications.

The area of transmission and data communications, particularly at high baud rates, was opened to competition at the end of 2000.

In the area of broadband internet access, cable company partnerships began to compete against the Company in March 2002.

In the field of telephony, according to an announcement made by the Minister of Communications, "HOT Telecom", a partnership of cable companies, began providing commercial services on November 25, 2004. As of September 2004, the Minister is entitled to grant special general licenses for the provision of domestic fixed-line communications services without an obligation to provide universal service or provide service with a limited deployment. To the best of the Company's knowledge, as at the date of publication of this periodic report, a license as aforesaid has been given to 012 Telecom Ltd. Furthermore, according to the amendment of the Communications Law in January 2005, the Minister is entitled to grant general licenses for telecommunications services or telecommunications activity and exemption by order of the licensing obligation. In November 2004, The Ministry of Communications issued a policy paper on the provision of telephony services over broadband access services (by the Company and by HOT), the policy being subject to a hearing. Likewise, the Ministry of Communications granted licenses for a "paid marketing trial" for provision of said services. See Section 2.6.1 below regarding this matter. Additionally, the Company views cellular telephony services as alternative services to the telephony services it provides. With regard to this matter, see Section 2.6.4 below.

Competition in the sector is dependent on a variety of factors, including: development of competition with HOT, issue of licenses to other domestic operators, the final policy to be determined regarding provision of telephony service over broadband infrastructure, increased competition with cellular companies; possible changes in the terms of the licenses of the Company and its subsidiaries as well as the conditions of the licenses granted to their competitors; mergers and joint ventures between companies that compete against companies in the Group; financing of the universal service; new services the Company will be allowed to provide; tariff policy and the amount of flexibility the Company is given in offering service packages, including along with subsidiaries etc.

For a description of developments in competition, see Section 2.6 below.

2.2 Products and Services

2.2.1 The Company provides a wide range of communications services to business and private customers. The main services offered by the Company include telephony services, associated services, and value-added services, internet access services – both dial-up and broadband access to high speed internet, transmission and data communications services over a wide variety of infrastructures for businesses and other communications providers.

2.2.2 Telephony

The Company's telephony services include, mainly, basic telephone services via household telephone lines, installations and transfers of telephone lines, sale of terminal equipment and other auxiliary services such as: Voice mail, caller ID, 144 information service, call waiting, follow-me, abbreviated dialing and conference calls.

Furthermore, the Company provides number services for businesses that enable incoming calls from anywhere through a single short speed dial (asterisk plus four digits), and via the 1-700, 1-800 area codes. These area codes enable business customers to determine whether the company or the customer will pay for the call.

The Company currently operates approximately 13,900 public telephones around the country that are operated by biodegradable prepaid cards ("Telecard"), billing a Bezeqcard or calling collect. In 2005, draft regulations were compiled, designed to ease the obligation of deployment of public telephones, but the draft was not approved by the

Knesset Economics Committee, which resolved that the Ministry of Communications should submit a revised draft.

In 2003, the Company submitted a request to the Ministry of Communications to terminate its Bezeqcard service (post-paid calling cards) and received the Ministry's agreement to such in principle. Some time later, the Ministry changed its view and on June 7, 2005, the then Minister of Communications handed down a ruling that the Company would not be allowed to cease providing the Bezeqcard service.

On July 10, 2005, the Ministry of Communications issued a paper on telephone number information services in an era of multiple communications providers for public comment. The Ministry gave notice that it intends to examine the need to amend the current arrangement for provision of information services, and that it would consider, *inter alia*, obliging each cellular operator to provide an information service to its subscribers, at no cost, for all cellular subscribers in Israel as a substitute for the current arrangement. The position of the public has been requested, *inter alia*, with respect to activation of a uniform information call center for all telephone numbers in Israel, or a separate call center for each operator, or for each level of communications (fixed-line, mobile), and activation of the center by communications operators only or by other operators. In a letter of response dated August 9, 2005, the Company submitted its comments on this matter, to the effect that, *inter alia*, these are auxiliary services to the basic service, and in an area in which the services provided are at a high level, and which already embodies the advantages of competition, regulatory intervention is likely to be harmful.

The Company's telephony services are among the main services provided by the Company, and in recent years they have been on a downward trend, in terms of both use and revenues. This is due primarily to the alternative services offered by the cellular companies and use of cellular phones which is, to a great extent, an alternative to making a call on a fixed-line phone.

2.2.3 Internet access services

These services enable internet access and primarily provide access to high speed internet over regular telephone lines using ADSL technology.

At the end of 2005, the Company had approximately 800,000 ADSL subscribers (compared with approximately 650,000 subscribers at the end of 2004 and approximately 771,000 subscribers as at September 30, 2005), amounting to approximately 65% of the broadband internet market in Israel (based on items in the Israeli media regarding the number of subscribers who are not subscribers of the Company).

The high speed internet market is one of the markets that have shown the most growth in recent years, and this growth is reflected in the Company's business. As hundreds of thousands of customers have subscribed to high speed internet services over the past five years, this service has become one of the Company's main operations and a major channel for its investments in technology, marketing, advertising and customer acquisition.

The high speed internet market is also marked by fierce competition against HOT, which offers high speed internet services over cable infrastructures.

2.2.4 Transmission and data communications services

Data communications services are network services for the point-to-point transfer of data over the Company's infrastructures, transfer of data between computers and various communications networks, services to connect communications networks to the internet and remote access services.

Data communications services are provided over established traditional infrastructures such as digital and frame relay lines, as well as over innovative and advanced infrastructures including ATM and IPVPN (Virtual Private Network). The IPVPN infrastructure enables managed communications solutions for businesses by connecting the various branches of the organization. In recent years customers have been switching from data communications solutions provided over older traditional infrastructures to IP-based infrastructures.

The Company offers transmission services, including high speed services, to its business customers and communications providers over a variety of protocols.

In 2004, the Company began providing point-to-point transmission services over Gigabit Ethernet protocol, which enables very fast, high volume transmission. As at the end of 2005, there were 77 such lines.

2.2.5 Other services

A. Services to communications providers

The Company provides services to other communications providers including the following: cellular operators; international operators; cable broadcasting licenses; the Israel Broadcasting Authority and The Second Authority for Television and Radio; network endpoint operators; ISPs; domestic operators; Palestinian communications providers.

Among the services provided by the Company are infrastructure services, connection to the Company's network, transmission services, billing and collection services, rental of space and provision of services at rented space, and provision of rights to use underwater cables.

B. Satellite and broadcasting services

The Company provides satellite services via fixed antennas (in the Ella Valley and the Ramla area), mainly including services for international communications: video transmission services and satellite relay broadcasts for foreign broadcasting organizations in Europe and Asia. The Company also operates mobile units for television broadcasts via satellite from time to time. The Company is also in negotiations with customers for the provision of internet and radio services via satellite.

Likewise, the Company provides users over a broad geographical area around the world with various kinds of mobile satellite communications services (such as: telephony, data communications and facsimile services) by operating a ground station for the provision of Inmarsat services in the Ella Valley. These services are granted by virtue of an agreement with Inmarsat Ltd. (which operates a satellite network that covers most of the world, land, air and sea). With respect to the Inmarsat Station, see Section 1.1.6 and Note 9F to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

The Company also currently operates and maintains seven radio networks operated by the Israel Broadcasting Authority, Channel 1’s television transmitters and those of Educational Television, Channel 2’s television transmitters and the transmitters of four regional radio stations.

The Company is only responsible for operation and maintenance of the transmitters in order to distribute broadcasts of radio and television programs, and not for the content of the broadcasts.

C. Work as a contractor

The Company performs setup and operation work on networks and sub-networks for various customers (such as the Ministry of Defense, cable television companies, radio and television broadcasting companies, cellular operators, international communications carriers, local authorities, municipalities and government agencies).

The Company and two cable television broadcast licensees (in this Section, the “Licensees”) have agreements for the provision of installation and maintenance services of cable networks for cable television using the Company’s infrastructure, from the starting point of the licensees’ operating point up to the point of delivery at the entrance to subscriber homes (the Company is not responsible for the connection and maintenance from these points to the subscribers’ homes).

D. Billing and collection services

The Company has billing and collection agreements with five international carriers. The Company also provides billing and collection services to another (sixth) carrier, on similar conditions, although no agreement has been signed with it. The terms of the agreements are similar and among other things stipulate that based on the data in the reports submitted by the carriers, the Company will collect payments due from customers for international telecommunications services through the phone bills it sends out to its customers and will transfer the actual amount collected, without bearing any responsibility for enforcement of collection. Additionally, the Company provides collection and sales services to terminal equipment resellers and collection services for information providers, internet service providers (ISPs), and network endpoint operators.

2.3 Breakdown of Revenues and Profitability of Products and Services

The following table provides data on the breakdown of the Company's revenues by the main products and services in its area of activity, which represent 10% or more of the Company's revenues (in NIS million and as a percentage of total revenues) over the past three years:

	2005		2004		2003	
	NIS millions	**% of revenues**	**NIS millions**	**% of revenues**	**NIS millions**	**% of revenues**
Telephony	3,093	65	3,223	65	3,462	66
Internet	550	12	505	10	440	9
Transmission and data communication	691	15	674	14	692	13
Other services	390	8	558	11	636	12

2.4 Customers

2.4.1 The Company is not dependent on any single customer or on a limited number of customers, which if lost would significantly impact on the area of activity.

2.4.2 The Company does not have any single customer generating revenues of 10% or more of its total revenues.

2.4.3 Company sales are divided into two main sectors: the private sector (approximately 60%) and the business sector (approximately 40%).

2.5 Marketing, Distribution and Service

2.5.1 The Company has marketing, sales and service systems for the private and business sectors, which include customer managers for the business sector, joint sales and service centers (including the 199 center) located throughout the country, separate technical support centers for internet and IT services, support and repair centers for telephone services (166 center), as well as 24 points of sale and service (Bezeq Store) around the country.

2.5.2 The Company primarily markets its services through advertising in the mass media and telesales centers, customer managers and through a system of independent marketers that includes ISPs, sales centers working by an outsourcing model, D2D and resale systems that operate points of sale in various shopping centers.

2.5.3 The Company's general license and the regulations stipulate standards for the availability and quality of the service the Company provides to its customers. These standards relate to the maximum amount of time to repair problems, maximum amount of time for installation or transfer of a phone line and for handling calls to information (144) and calls to report problems (166). The Company has applied to the Ministry of Communications, asking to adjust the standards defined in its license to reflect actual practice and to match those in the licenses of other providers in order that the Company might comply with such. As at the date of publication of this periodic report, the standards have not been adjusted as aforesaid.

2.5.4 The Company also operates service and support centers for all customers and provides them with a variety of services, including billing questions, ordering of various services and technical support for internet and IT services.

2.6 Competition

The following is a description of the development of competition in the fixed-line domestic communications market:

2.6.1 Telephony

In November 2003, a general license was granted to the partnership formed by the cable companies, HOT Telecom (hereinabove and hereinafter: "**HOT**"), for the provision of fixed-line domestic services, including telephony. According to the notice issued by the Ministry of Communications, HOT began providing telephony services on November 25, 2004.

On August 1, 2004, a temporary order entered into effect, stipulating that for a period of two years from the date on which HOT began its commercial activities or until a difference of up to 1.05 billion traffic minutes is generated between calls that end on the Company's network and those that end on HOT's network, whichever comes first, interconnectivity fees for termination of the calls on said networks would not be paid. For additional information on this, see Note 1E(1)D to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

Competition with HOT is increasing, and is expressed, *inter alia*, in offers by HOT which combine broad band internet, telephony and cable television, aimed mainly at households. In addition, HOT markets telephony services to business customers. According to media reports, HOT's telephony service has more than 80,000 customers, as at the end of 2005.

Following the adoption of the recommendations of the Kroll Commission, which was appointed to set guidelines for competition in the area of fixed-line telecommunications, and the accompanying legislative amendments, as of September 2004, the Minister is entitled to issue special general licenses for the provision of fixed-line domestic telecommunications services, including telephony, with no obligation to provide universal service or minimal geographical deployment. On December 25, 2005, such a special general license was granted to 012 Telecom Ltd. (in the Golden Lines Group). To the best of the Company's knowledge, Cellcom and GlobeCall have also applied to the Ministry of Communications to obtain such a license.

VOB[6] Service Policy

On November 30, 2004, the Ministry of Communications issued a policy paper on the provision of telephony services over broadband access systems of a fixed-line domestic operator (in reality – the Company's and HOT's) (hereinafter: "**VOB Services**"). According to the policy paper, the intention was to enable VOB services to be provided under the special general licenses in 2005; a VOB operator will pay mutual interconnect fees, but will not pay for use of the fixed-line operator's network. The Company itself will only be allowed to provide this service from May 1, 2007 or after its market share in telephony falls below 85%; provision of international VOB services will be allowed by any party that provides the full range of international services. The company communicated its opposition to said policy to the Ministry of Communications.

Following the responses received from the Company and HOT, the Ministry announced an additional hearing for holders of general licenses regarding the implications of the aforementioned guidelines. On January 30, 2005, the Company submitted another response to the then Minister of Communications, demanding another thorough investigation of the matter, along with careful study of all aspects and its significant implications. The Company once again clarified: that VOB services conflict with the concept of independent infrastructures which are the basis for the regulation of the fixed-line telecommunications market in Israel; the Company is entitled to provide fixed-line telephony services in any manner whatsoever and it cannot be prevented from providing VOB services; provision of VOB services should also be allowed over cellular networks, if and when the provision of VOB services over fixed-line networks is allowed as the lack of symmetry will very seriously and negatively impact operators; an appropriate solution for the question of cross-subsidy needs to be found; VOB operators

[6] Voice Over Broadband

need to pay an interconnect fee; and the level of regulation of the Company needs to be significantly more flexible, with specific reference to regulation of tariffs to enable the Company to compete in the new conditions.

The Ministry of Communications has, *inter alia*, notified the Company and its subsidiaries on 20.4.05 that in completing preparation of the policy and following study of the remarks submitted in response to their enquiries, it is considering making an amendment to the policy paper so that the Company or a subsidiary of the Company will be able to provide VOB services after the Company's market share in fixed-line domestic telephony in a particular customer segment falls below 85%. In addition, the Ministry intends to set two review dates, in November 2006 and November 2007, to look into the possibility of permitting the Company or a subsidiary of the Company to provide VOB services even if the Company has not lost 15% of that market share, noting the developments in competition in the field of telephony.

The Company views this amendment as a possible worsening of its position, and of its subsidiaries, and has given notice to the Ministry of Communications that the amendment that it is considering, as set out above, contravenes the policy principles document. On May 25, 2005, the Company once again contacted the Ministry of Communications, asking for an oral hearing before the then Minister of Communications. In its letter, the Company once again clarified, *inter alia*, that it should not be denied the ability to provide VOB services, and that such denial would contradict the license and the law, would be unprecedented anywhere in the world, and would severely harm the Company and its customers;

The hearing of this matter at the Ministry of Communications has not yet finished.

Concurrent with publication of the policy document regarding VOB, trial licenses were granted for marketing of VoIP services in return for payment to a number of entities, including Golden Lines, Barak 013 and Bezeq International (which was recently extended to the end of August 2006, the notice of extension stating that if the policy that is set does not allow Bezeq International to provide VOB services, then the trial license will expire).

Following a joint discussion at the Ministry of Communications between the Company and the carriers wishing to operate this service, the Ministry of Communications issued a directive to activate the dialing directions and numbering ranges allocated for use of the trial marketing licenses on the Company’s network. In another letter from the Ministry of Communications, it was clarified that the Company will not bear "expenses in kind" of the trial, and that if additional payment is determined as part of the VOB policy, that payment will apply retroactively also for the trial period. As at the date of publication of these Reports, dialing directions have been opened to three licensees (one of which is the subsidiary Bezeq International Ltd.) and the Company is in advanced negotiations with another trial licensee for connecting it up to the Company’s network.

See also Sections 3.7.2 and 4.1.5 below.

2.6.2 Broadband internet access

The field of broadband internet access has become fiercely competitive since the partnership of the three cable companies (now a merged partnership, “HOT”) began competing against the Company in March 2000.

HOT has access to a cable and fiber-optic infrastructure over significant parts of Israel and a relatively high penetration rate into homes in those areas. The cable network underwent a major upgrade recently and is currently an advanced broadband digital network. Over this network, it is possible to provide a wide range of advanced communications services and advanced interactive applications. This network is currently the main universal alternative for competition against the Company in the private sector.

2.6.3 Transmission and data communications

At the end of 2000, segments of this area began to open to competition, as special licenses were granted for the provision of transmission services to licensees - Cellcom, Med-1 and Golden Lines. In November 2002, the licenses of Cellcom and Med-1 were expanded to include the provision of high-speed data communication services to organizations. The licenses prohibited the provision of voice, video and access services to ISPs as well as assistance with the implementation of these communications services in any manner whatsoever. At a later stage, these licenses were amended to allow Cellcom and Med-1 to provide access services to ISPs at symmetrical speeds above 2 Mb/s. Furthermore, to the best of the Company's knowledge, restrictions on Cellcom were eased somewhat with regard to the prohibition on provision of video services.

Cellcom has set up an independent backbone to connect its switches, which it uses for both its own purposes (instead of transmission which in the past was provided by the Company) and for competition against the Company in the transmission and data communications market.

HOT and Med-1 can be counted among the significant competitors in this market, given that they own a widely deployed fiber-optic network, as can the Internet companies which use leased infrastructures. Completion of the transaction by Partner to acquire the operations of Med-1, if and when completed, might make competition in this field stronger, whilst harming the Company's revenues from services that it provides to Partner.

In September 2005, the Accountant-General published a tender for the provision of data communications services to government ministries and adjunct units in an amount that covers a significant portion of the data communications market in Israel. The Company filed an administrative petition, applying to cancel or amend the tender. The court dismissed the application to cancel the tender, but cancelled a principal condition which related to the method of weighting the price of offers and instructed the Accountant General to rethink the issue, and to examine the Company's allegations. Following the judgment, the Company asked the Accountant General to summon representatives of the Company who might plead for it. The Accountant General dismissed the Company's application to make claims before him, and sent an amended decision regarding the price weighting. The date for submission of bids was set down for March 1, 2006. Likewise the Company filed an appeal in the Supreme Court against the judgment, and an application to stay execution, claiming that not only had the Court ruled in the judgment that the tender was being held in contravention of the principles of tender laws, and was harmful to equality, confidentiality and competition, but the final decision did implement the aforesaid findings in such a way as to ensure that the harm to the Company would be reduced. The Supreme Court ruled that the Accountant General should submit his response to the application to stay execution by March 2, 2006, and should make reference therein to the possibility that the envelopes submitted not be opened prior to the date of ruling on the appeal, and that hearing of the appeal be brought forward.

2.6.4 Competition from the cellular companies

The penetration rates of cellular technology in Israel are among the highest in the western world. The Company's opinion, which is not accepted by the Ministry of Communications, is that the penetration rate, combined with airtime tariffs which are low in international terms, have made cellular phones a product which is largely interchangeable with telephone lines. Recently, the declining trend in the number of voice minutes over the Company's network has flattened out *inter alia* as a result of a slow-down in the rate of growth of the cellular companies. The Company believes that increasing interchangeability between fixed-line and cellular telephones is one of the reasons for the growing rate at which telephone lines are being removed, to the extent that approximately 14% of Israeli households today do not have a fixed line (compared to approximately 5% in 1996). According to the Company's approach, that mobile telephony services are largely interchangeable with fixed-line services, the Company has appealed to the Antitrust Tribunal against the refusal of the Antitrust Commissioner to rescind the declaration of the Company as a monopoly, and its appeal is pending.

Cellcom has declared its intention of entering competition in the market for domestic communications, under certain conditions, and has recently submitted, to the best of the Company's knowledge, an application for a special general license for provision of domestic fixed-line communication services. To the best of the Company's knowledge, Cellcom has deployed a fiber-optic infrastructure reaching, *inter alia*, industrial and commercial sites, office buildings and business centers. This infrastructure could be used by Cellcom to connect business customers to its installations in order to provide communications services as an alternative to the services the Company is currently providing to some of these customers. Entry into the fixed-line domestic telecommunications market may enable Cellcom to offer its customers a complete line of solutions, including domestic telephony, and data and cellular communications, while using its own infrastructure and experienced sales system.

According to media reports, Partner has also announced its entry onto the fixed-line domestic telephony market, based on the principles set out in the policy paper issued by the Ministry of Communications on the provision of telephony services of broadband access services.

2.6.5 Additional factors that may affect competition

A. Numbering and number portability

Under the Communications Law, in order to guarantee competition and the level of service in the telecommunications market, the Minister is authorized to issue directives to licensees regarding designation and allocation of telephone numbers and dialing rules, preparation and management of a numbering plan, and its operation and application. The Minister may order each licensee to bear the costs, in whole or in part, it incurs in complying with the directives, and if licensees should incur shared costs in respect of number portability, the Minister may order that they be divided among the licensees. According to a directive issued by the Ministry of Communications, certain area codes in the Company's network have been unified.

On March 29, 2005 the Economic Policy for Fiscal 2005 (Legislative Amendments) Law, 5765-2004 was passed by the Knesset, containing, *inter alia*, an amendment to the Communications (Telecommunications and Broadcasts) Law, 5742-1982 (hereinafter: the "**Communications Law**"), whereby the Minister of Communications will prepare a numbering program for the matter of number portability with regard to a holder of a general license (including a special general license) for fixed-line domestic communication, and with regard to the holder of a general license for the provision of cellular services, and will instruct them concerning its implementation and operation by September 1, 2006 (if the Ministers of Communications and Finance see that there is a real need, and for special reasons, they may postpone, in an order and with the approval of the Knesset Economics Committee, the implementation and operation of the program for a period not exceeding three months).

Notwithstanding the Company's position, and to the best of its knowledge, that of other licensees, that it is not possible to meet the timetables prescribed in the draft transferred to the licensees, including the Company, a numbering plan to implement number portability was signed by the Ministry on August 22, 2005. In this regard, see the Company's immediate report dated August 24, 2005, and Note 1E(1)F to the financial statements of the Company for the year ending December 31, 2005, included in this periodic report.

As the Company noted in its reports and in detailed letters sent to the Ministry of Communications, it will not be possible to meet the timetables set out for implementation of the plan (the signed numbering plan only extended the internal dates – the milestones for planning and installing means for activating number portability – by three months, however the timetable for implementation of number portability flowing from the Law remains as it was). Apart from that, implementation of the plan is likely to require the Company to effect significant investments, which is likely to adversely affect the Company's ability to compete, as well as that of some of the companies in the Group. In an immediate report published by the Company, the Company noted that it was studying the signed plan in comparison with the draft plan and that it intended to continue with its efforts, *inter alia*, to convince the Ministry regarding the need to prescribe more reasonable timetables.

As the Company further noted in an immediate report on March 23, 2005, the implementation of number portability will necessitate considerable financial investment in replacing software and hardware versions in the Company's switching system. In addition, substantial financial investments will also be required in the Company's information systems, which could also lead to postponement of the Company's development plans in this area. The activation of number portability also involves costs for joint registration and administration with relevant operators. These are costs that cannot yet be fully estimated. In addition to the aforementioned expected costs, the implementation of number portability, which will facilitate customer transition from the Company's network to the networks of its competitors, is liable to adversely influence the Company's ability to compete.

No response has been obtained to the Company’s letters to the Ministries of Communications and Finance. On December 18, 2005, the response of the Minister of Finance to the Company’s letter of December 13, 2005 arrived, stating that he saw no room to postpone implementation of the law in this regard. On January 1, 2006, the chairman of the forum of carriers wrote to the Minister of Finance requesting a hearing for all of the carriers regarding the timetables, and proposing to amend the law so that final implementation be postponed by one year. On January 12, 2006, the Company responded to the letter from the Minister of Finance, noting that he undertake to hold a hearing for the carriers. The Company also suggested that the law be amended so that the Minister of Communications be given authority to postpone implementation of the plan until at least the end of 2007.

On October 16, 2005, the Company was given a permit to operate a national area code with the prefix 076. Operation of a national area code will enable the Company to allocate national numbers, which is likely to facilitate the provision of national services.

B. Other potential competing infrastructures

In addition to the cable companies’ cable and fiber-optic network and Cellcom's fiber-optic infrastructure, there are a number of fiber-optic networks in Israel today, most of which are owned by State-owned companies or government agencies. These include Israel Electric Corporation, Israel Railways, Mekorot, the Oil Infrastructure Company and the Cross-Israel Highway Company.

In the aforementioned government decision of August 15, 2004, it was decided to have the Director General of the Ministry of Communications take action to enable the provision of domestic transmission services, hosting services for communications services and broadband internet access services over existing infrastructures in which the State has holdings in various areas (including electricity, railway, Mekorot, Trans-Israel Highway, the Oil Infrastructure Company and others), as at March 1, 2005, and to make the required legislative amendments to the laws that regulate the activity of the owners of said infrastructures. Note that some municipalities are attempting to create an alternative to the laying of pipelines by communications licenses, via the infrastructure held by such municipalities.

On January 31, 2006, the Ministry of Communications published a request to receive public positions regarding the policy of allocation of frequencies to the wireless access network by February 28, 2006. According to the Ministry, following applications from existing licenses and commercial entities for allocation of frequencies for the purpose of operating a wireless access system in order to provide a variety of fixed-line communications services, the Ministry is considering amending its policy on allocation of frequencies for the purpose of operating wireless access systems, which will enable the provision of fixed-line communications services.

C. Advantages and technological developments

Cellular operators and international telecommunications service providers have a relative advantage when entering the area of provision of fixed-line domestic telecommunications services, given the existence of exchanges, switching equipment and customer base for telecommunications services.

The Company’s assessment that real competition will develop in the market, harming market segments, rests on frequent technological developments and breakthroughs in the various fields of communications. Technological progress is expected to enable competing companies to introduce technology quickly at a relatively low cost, which will enable supply of telephony and data communications services over private and public IP networks, as well as via advance cellular infrastructure, and advanced generation wireless infrastructure.

Another competitive factor is the “Bezeq-bypass networks”. There are two main types of bypass networks: (1) those built on the Company's infrastructure –

primarily various types of point-to-point lines, such as Sifranet and frame relay which compress speech channels and are used by organizations dispersed over a large number of sites around the country, and use of the internet infrastructure; (2) those that use other infrastructures or divert traffic to them, and primarily different types of wireless-cellular, microwave, laser, satellite networks and cellular adaptors. Systems using a combination of both of these types also exist.

The rapid growth in the number of broadband internet subscribers, improved quality of sound and increasing awareness of use of the internet to make cheaper calls negatively affect the number of calls passing through the Company's network and are causing a decline in its revenues. VoIP technology is based on packet-switching and enables more efficient use of bandwidth and a reduction in call costs.

In the business sector there is also a common trend of bypassing the Company's switched telephony network, either through cellular adaptors installed by the customers themselves or by the cellular companies (installations on the customer's premises enabling conversion of calls originating from a fixed line to the cellular spectrum) or by NEP licensees.

The Company believes that the said network bypasses along with the interchangeability of fixed-line and cellular services explain a substantial part of the decline in traffic minutes on its network. In addition to the technologies and methods described above, additional technologies and methods are being developed and are likely to be developed in the future, and these will even further reduce the use of the Company's telephony, data communications and transmission networks.

2.6.6 <u>The Company's preparations for coping with increasing competition</u>

The Company is coping with competition in fixed-line domestic telecommunications services in several ways:

A. The Company is launching new communications services and value-added applications, among other reasons, to increase the volume of use of subscriber lines, respond to customer requirements and enhance the image of technological innovation. The Company invests in improving and modernizing its infrastructure in order to be able to provide its subscribers with advanced services and products.

B. The Company took action to introduce broadband (high-speed) internet services using ADSL technology and is working to maintain its market share in this area. In December 2003, the Company launched the "IPVPN secured business access service", which provides secure connectivity of branches and enables employees to connect from their homes to their organization's network. It also launched an ADSL-based service for business customers and high-speed data communications services for business customers and communications providers.

C. The Company is constantly working to improve the quality of its services and to preserve its customers, and since the end of 2005, these activities have been run as a special project, which focuses solely on them.

D. The Company has simplified its tariff structure and offers customers a number of alternative payment packages.

E. The Company is implementing a new billing system for business customers.

F. The Company is working to heighten awareness of use of the fixed-line telephone and to promote the use of other services which increase telephone use, such as numbering services (1-800), voice mail, marketing of digital cordless phones (under the B Digital brand), telephone information services and other value-added services.

G. The Company has entered into contractual arrangements with business customers for a defined period (generally three years, in rare cases – five years) to promote increased use of its services by assisting in the financing of communications equipment or annual financial bonuses in the form of discounts which the Company believes it is permitted to give. The Ministry of Communications believes that these agreements contravene the provisions of the Company's license, and it informed the Company that if said agreements are not cancelled, it intends to call in NIS 8 million of the bank guarantee the Company provided in accordance with its licenses. The Company disputes the position taken by the Ministry of Communications and has appealed to the High Court of Justice in this matter. The High Court of Justice issued an order staying rescission of the existing agreements and the calling in of the guarantee pending hearing of the case.

On March 28, 2005, the High Court of Justice ruled that the interim order staying rescission of the agreements between the Company and business customers be left in place pending further ruling. However, in the same ruling, the High Court of Justice stated that there was nothing to prevent forfeit of the sum of NIS 8 million by the Ministry of Communications, out of the bank guarantee given to it by the Company. As at the date of publication of this report, the Ministry of Communications has not taken any action relating to forfeit of the guarantee. “Hot-Telecom” has been joined as a respondent in the petition. On November 17, 2005, a hearing was held in the petition, and as at the date of publication of this report, a ruling has yet to be handed down.

H. The Company is adjusting expenditures with the goal of reducing investments in fixed assets while at the same time diverting resources to growth activities and reducing operating costs. The Company has a policy of selective investments, effective utilization of existing resources and reducing the prices of the equipment and services it purchases. The Company has also changed the mix of its investments: less emphasis on investments for maintenance of existing items and heavier emphasis on development of growing services (such as ADSL and IPVPN), and the integration of advanced information systems for achieving its marketing and business-related goals. Notwithstanding the foregoing, the Company's ability to make adjustments in its expenses in the short and medium term is limited due to its cost structure, which mainly comprises rigid short- and medium-term costs. These costs consist principally of depreciation expenses and expenses related to salary and benefits. Furthermore, the Company has other operating costs such as infrastructure maintenance and leasing as well as maintenance of buildings, which are also rigid short-term costs.

I. At the end of 2005, a change administration was set up at the Company in order to implement changes in the organizational structure of the Company, the purpose of which was to make the Company more compliant with a competitive market, by focusing on customers, and achieving operational and procedural efficiency.

J. The Company is looking at how it will integrate itself into a process which is hitting most of the communications companies around the world, to deploy a unified infrastructure, under a network topology known as the Next Generation Network (NGN) for transmission of voice communications, high-speed internet communications and content, leisure and entertainment applications.

2.6.7 Positive and negative factors that affect the Company’s competitive status

Positive factors

A. A modern infrastructure that is deployed throughout the country and technological innovation through which a variety of services are provided.

B. Presence in most businesses and households.

C. Strong capital structure and positive cash flow.

D. Expansive service infrastructure and various customer interfaces.

E. Professional, experienced and trained staff.

F. Brand with presence and power.

G. Tariffs that are among the cheapest in the world.

Negative factors

Regulation

The Company believes that the various restrictions imposed on it under the existing regulatory guidelines impede and will continue to impede its ability to compete in its areas of activity as competition increases. The following are the main restrictions in this regard:

A. Obligation of structural separation

Under its license, the Company must maintain full structural separation, in the form set out in the license, between itself and those subsidiaries and affiliated companies that are specified in the license. At this stage, these restrictions do not apply to the other organizations operating in the communications market, and thus put the Company in an inferior position. There is also a separation between the Company's operations and those of Pelephone due to the conditions of the merger approved by the Antitrust Commissioner.

B. Restrictions on the marketing of packages of services jointly by the Company and companies in the Group

The Company believes it should be permitted to offer packages of services jointly with companies in the Bezeq Group, when these types of packages are offered by its competitors. The absence of such an option is a major disadvantage in the Company's ability to compete.

C. Lack of tariff flexibility

The Company is restricted in its ability to grant discounts on its principal services and to offer differential tariffs. Even the tariff packages (which were supposed, among other things, to offer an immediate alternative to the normal tariffs) are so tied up in bureaucracy that they are frequently pointless.

Furthermore, the combination of the present supervisory mechanism and the restrictions that apply in relation to the structural separation, prevent any possibility of the Company being able to offer customers packages containing all communications services.

D. Universal service obligation

The Company is obligated to provide universal service to the entire public in Israel. This obligation will not be imposed on the special local carrier licensees, which will be able to offer their services to the Company's profitable customers (particularly business customers), which represent a significant source of revenues for the Company. The Company believes that a fund should be established to finance this universal service, so that a carrier that does not provide service to any party requesting it will pay into the fund through which the universal service will be funded.

E. Cross-subsidy

Due to regulation, the Company's tariffs include a cross-subsidy between traffic and access. This issue is in any case one of the most substantial difficulties the Company has in competing, and yet the competition relies on Bezeq's infrastructure and takes advantage of the access subsidy (such as VOB Services), so the negative impact of this factor has grown.

Labor relations

The Company's labor relations make flexibility of its operations and its ability to deal with competition more difficult. Implementation of plans for structural changes and significant reduction in the number of employees, as part of making the Company more competitive, in the past required and in the future is also expected to require coordination with the employees, come at a significant expense and cause unrest in labor relations.

Cost structure

The Company's cost structure is based on a relatively high component of hard expenses which will be difficult, in the immediate future, to adjust to the increasingly harsh conditions of competition.

Competition

The extent to which competition impacts on the Company (including positive implications) and on its revenues is dependent on a variety of factors, including the following: the rate at which competition with the cable partnership and other domestic operators develops; increased competition with cellular operators; the final policy set regarding provision of telephony services over broadband infrastructure; the ability to leverage the synergy between companies in the Group and the flexibility the Company will be given to offer joint packages of services and to determine its tariffs; tariff erosion; approvals for new services, and allowing the Company to implement applications, services and transfer of content enabled via advanced technology (such as: IPTV), combination of fixed-line and mobile services; financing of the universal service; changes in licenses; symmetry in structural separation obligations; implementation of economies of scale; the ability to retain and increase its portion in the various areas in communications.

2.7 Fixed Assets and Facilities

2.7.1 The Company's fixed assets primarily include: real estate (property and buildings), domestic telecommunications infrastructure, exchanges, various networks, computer systems, vehicles and office equipment.

2.7.2 <u>Fixed-line domestic telecommunications infrastructure</u>

This infrastructure is comprised of five principal components deployed throughout the country.

A. <u>Exchanges</u>

Used for switching calls and transferring them from their origin to their destination based on the signal (dial) received from the subscriber.

B. <u>Transmission network</u>

A system through which there is connectivity between exchanges. This system actually functions as a national backbone that connects the local networks, which each comprise an exchange and an access network. The transmission network is based primarily on fiber-optic systems and in part (minimal) on radio systems.

C. <u>Data communications networks</u>

Networks for the provision of data communications services at various speeds.

D. <u>Access network</u>

A system that connects subscriber network end points to the exchange. The network is based on copper pairs, fiber-optic cables and in part (minimal) on wireless systems.

E. <u>Terminal Equipment</u>

Equipment installed at the subscriber site (such as telephones, private exchanges, fax machines, modems, routers, etc.) through which the subscriber receives the service.

2.7.3 <u>Computing</u>

The Company's IT system supports four central areas:

A. <u>Marketing issues</u>

The computing system supports, *inter alia*, management of the customer database, management of orders of services, management of follow-up of customer complaints, management of sales and customer service processes, and billing. The billing and collection system includes production of bills to customers for services provided and for services of other communications carriers. This includes the managing of accounts with communications suppliers.

B. <u>Information systems for engineering infrastructures of the telecommunications networks</u>

Support planning, management, control and maintenance of engineering resources for the purpose of supply and assurance of services. *Inter alia*, the systems manage the number inventory and support massive conversions of numbers and equipment.

C. Information systems for management of Company resources

Support management, control and maintenance of the expenses of the Company, financial information (including budget and controls), procurement and inventory processes, property, real estate, human resources and wage controls, vehicle fleet, Company projects, etc.

D. Cross-organization systems

Support decision-making processes via a data warehouse system (DWH) operated by the Company. The Company also has an internet site which provides information regarding the Company's services, and allows for the presentation of information regarding telephone bills, payment of telephone bills and additional services. Computerized office systems (electronic mail, resolution follow-up, etc.), knowledge management systems, etc. are also operated by the Company.

The IT system is made up of hardware (physical infrastructure, computers and various other kinds of equipment) and the information system (software, applications, information systems, etc.). The hardware system includes a central computer, a collection of servers, information storage units, a communications network and a collection of terminal stations which serve all of the units of the Company. The information structure, which is made up of a collection of information systems, operates in various computing environments, the components of which are linked in many ways.

The Company's IT system is large and complex, supports mission-critical work processes and handles very large amounts of data. The system is made up of a large number of systems, some of them old systems developed many years ago, operating on central computers, and some of them modern systems developed and implemented in recent years, operating in open computer environments.

2.7.4 Real Estate

A. General

The Company's real estate assets come from two sources: Assets transferred to it by the State under an asset transfer agreement in 1984 and assets to which the Company received or purchased rights after this date, including assets it leases from third parties.

The Company owns or has long-term leases over some 415 real estate assets around the country. The total area over which the Company has full title or capitalized long-term lease rights (including joint long-term lease rights), amounts to some 710,000 m^2 of land, of which some 370,000 m^2 is built up. Six of these properties are in Israeli settlements in Judea and Samaria, approximately 7,000 m^2 in area, with a total of 500 m^2 being built up.

In addition to those properties, there are another 14 properties, with a total area of 1,585,000 m^2, which are set out, in the agreement for the transfer of properties, as being under leases renewable every two years, and under the settlement agreement described below (hereinafter: the "**Settlement**"), this land is to be leased to the Company.

Of all of the properties owned or leased long-term, 66 of them are properties which were under joint title with the Ministry of Communications, the rights of the Ministry in most of which having been transferred to the Postal Authority, to the best of the Company's knowledge. The total area of these properties is some 126,000 m^2 of built-up land on plots totaling close to 130,000 m^2 (according to the data set out in the agreement for the transfer of properties). On June 30, 2004, The Company entered into an agreement with the Postal Authority to define and clarify the rights of both in these properties (see Section 2.17.2(c) below).

The parties are following the provisions of the agreement, *inter alia*, to separate joint charges and systems.

Furthermore, the Company holds some 75 properties in Israeli settlements in Judea, Samaria and the Gaza Strip, in a total area of approximately 10,500 m^2 of land, on which about 1,800 m^2 is built up. No written arrangement of the contractual rights in these properties exists, but in the Company's opinion, this does not constitute a significant problem.

The Company uses this land for communications operations (switchboards, concentration rooms, broadcast sites, etc.) and for other operations (transmitters, warehouses, etc.). Some of the Company's properties are partially undeveloped or partially development, and can be exploited further.

The Company leases about 130 land assets, with a total area of 77,000 m^2, of which 72,000 m^2 are built-up, from various lessors.

The Company has easements (rights of way, etc.) over other real estate (i.e. in order to erect transmitters and deploy cables). The Company also has about 330 concentration rooms at its disposal (rooms for cables and installations for the purpose of neighborhood communications), with a total area of approximately 4,400 m^2, most of which are not regulated by written arrangements of rights with the owners (such as: The Israel Lands Administration, settling organizations, entrepreneurs of projects on which the properties are situated, and cooperative house committees).

B. Registration

As of the date of this periodic report, the Company's rights in a considerable portion of its land assets are not registered with the Land Titles Registration Office and are therefore merely contractual rights. The Company is in the process of registering those land assets which can be registered in the Land Titles Register.

C. The Settlement regarding the Land

On March 10, 2004, the Settlement signed by the Company, the Israel Lands Administration (hereinafter: "ILA") and the State was given the force of a judgment after a drawn out dispute over most of the real estate assets transferred to the Company under the real estate transfer agreement which was executed when the Company began its commercial operations.

Under the Settlement, 14 properties specified in the agreement will be returned to the State through the ILA on different dates (by 2010) and in accordance with the terms stipulated in the agreement (hereinafter: "Returned Assets"), out of the 31 assets in the asset transfer agreement which will be under leases that will be renewed every two years. Three additional properties in this category were returned to the ILA prior to the Settlement. Fourteen additional properties in this category which were specified in the agreement (hereinafter: the "Properties to be Retained"), are to remain in the Company's possession, under capital lease conditions as set forth below.

As at the date of publication of this periodic report, of the abovementioned assets, the Company has returned 10 assets to the ILA.

In addition to the Properties to be Retained by the Company, about 220 properties under long- term leases stipulated in the real estate transfer agreement (hereinafter: the "Properties under Long-Term Lease"), with the exception of a number of properties of an insubstantial cumulative value, are to be returned to the State. Of all the properties under long-term lease, 66 are held jointly by the Company and the Postal Authority and/or the Ministry of Communications. It was determined that the rights of the Company in these properties under the Settlement will also be determined by the area in the use of the Company in said properties as will be determined or agreed upon in the future between the Company, the Postal Authority and/or the Ministry of Communications, as applicable (in this regard, see Section 2.17.2(c)). Note that over the years (both before and after the Settlement), the Company has sold approximately 20 assets (in whole or in part) out of the properties under long-term lease, such that as at the date of this periodic report, there are approximately 200 assets in this group of assets.

From the date the agreement entered into force, the Company's rights in the Properties to be Retained shall be as follows:

The Company and the ILA shall act within 180 days of the date the Agreement enters into effect to sign long-term lease agreements at 91% capitalized for each of the properties (as at the date of publication of the periodic report, approximately 20 lease contracts for assets under this category have been signed between the Company and the ILA); the Company's rights in properties are to be long-term lease rights for a period of 49 years commencing on March 22, 1993, with the Company having an option to extend the term of the long-term lease for another 49 years in accordance with the ILA's procedures at the time regarding other long-term lessees in the municipal sector; the purpose of the lease shall be any permitted purpose under the plans applying and/or that may apply to the properties, and the Company shall be entitled to make any use of and do any act to such properties, at its discretion, as part of such long-term lease purpose; the basis for the Company's rights in the properties shall be the plans as defined in the Planning and Building Law, 5725-1965, lawfully approved on March 22, 1993; the Company shall not make any payment to the State and/or the ILA, including permit fees, lease fees, capitalization fees - until exploitation of all rights under plans lawfully approved as of March 22, 1993; subject to the execution of individual lease contracts as set forth in the foregoing, the Company shall be entitled to effect any transaction permitted under law on the properties, at its discretion, and without being required to pay the ILA for performance of such transaction. The Company shall be entitled (subject to execution of individual long-term lease contracts as stipulated in the foregoing) to make improvements to the properties, subject to any law. In the event of any improvement, over and above the basis of the rights as set forth above, the financial arrangements stipulated in the agreement shall apply.

D. Properties with improvement potential

The Company is examining the possibility of developing and exploiting those of its land assets which are currently undeveloped or partially undeveloped, for instance by exploiting additional building rights, amending plans under the Planning and Building Law, or sale of assets. Following the Settlement, which removed the uncertainty regarding the Company's rights and the Properties to be Retained, and defined them, it is possible to move forward with exercising the potential to improve such properties. The considerations are mainly based on criteria of the size, location and use of the real estate.

2.8 Intangible Assets

2.8.1 The Company's general license

The Company operates under the terms of a general license which, *inter alia*, serves as the foundation for its fixed-line domestic telecommunications activity (for a description of the principles of the general license, see Section 2.16.2 below).

2.8.2 Trade Marks

The Company uses trademarks that reflect its products and services.

As of the date of this periodic report, the Company has approximately 50 trademarks registered in its name at the Registrar of Patents and Trademarks. The main trade marks are:

"Bezeq" – Company name.

"B BEZEQ" – Company logo.

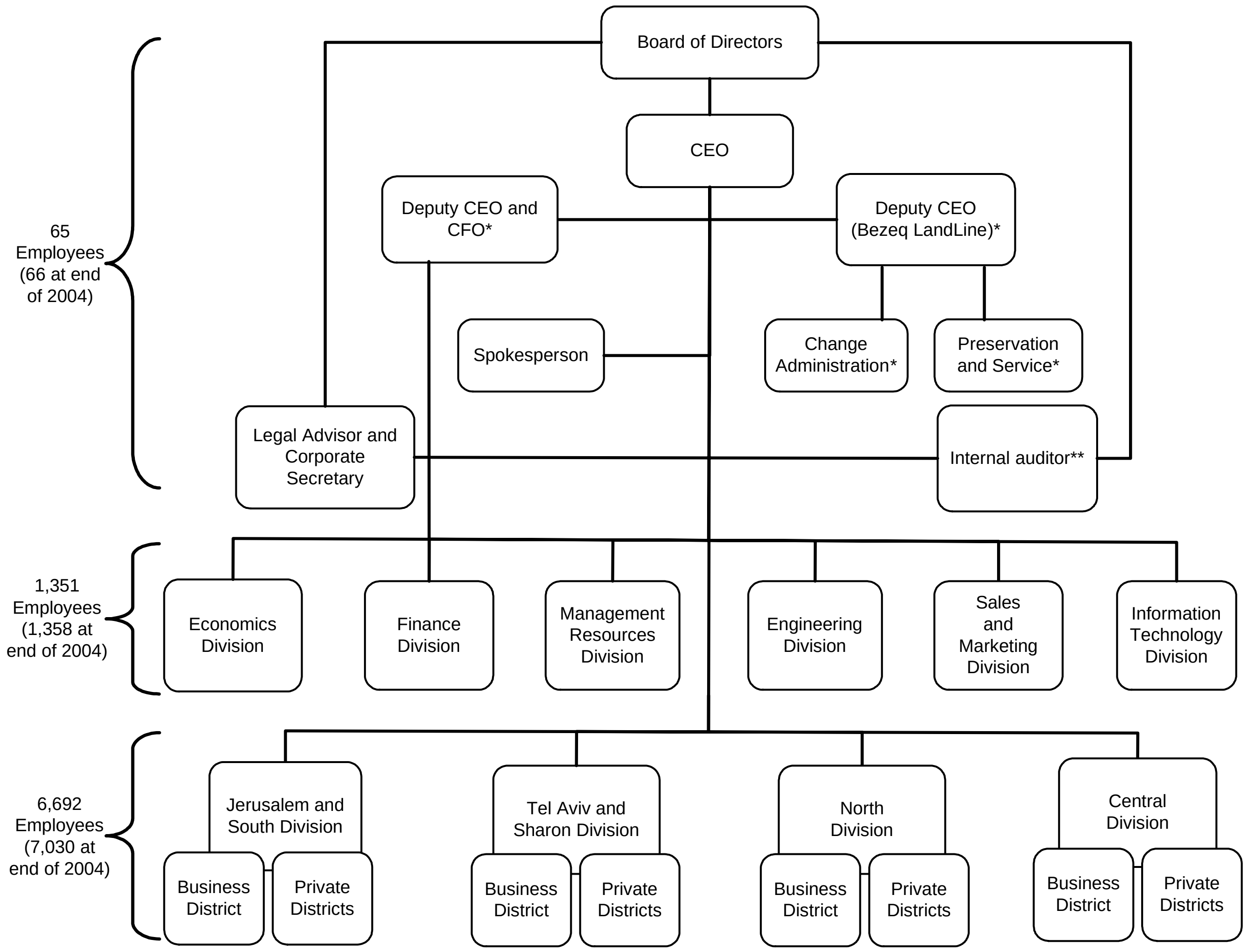
"WOW" – access to the Company's high speed internet services.

Advertisement of the main trademarks is done in the various media outlets such as the press, radio, television, billboards and mailings.

The investment in advertising the trademarks is intended to increase the level of public exposure and awareness of the trademarks in order to create differentiation which will have an effect on customer purchasing decisions and preferences.

2.9 Human Capital

2.9.1 Organizational structure and personnel based on organizational structure (as of December 31, 2005)



* As of the end of 2005.

** Pursuant to a resolution of the board of directors of the Company, in terms of organizational structure, the auditor reports to the chairman of the board of directors.

The Company is working in coordination with the workers' organization in order to bring about a change in the Company's organizational structure, with the aim of making the Company compatible with the competitive market in which it operates, by focusing on the customer and achieving operational and procedural efficiency. In this context, a change administration is working in the Company on concentrating and coordinating the change plan, responsible for designing the new organizational structure, for designing the new processes, for determining the necessary human resources and job descriptions, and for preparing the implementation and adaptation plan. The change administration is also responsible for defining indexes and goals and coordinates the work of all of the Company's improvement teams operating on a variety of core issues.

2.9.2 Personnel according to employment framework

Employment Framework	Number of Employees		Description of Employment Framework
	As at December 31, 2005	As at December 31, 2004	
Contracts for senior executives	84	87	Managers excluded from application of the Company's collective bargaining agreements. Their terms of employment are set in personal agreements.
Permanent	3,995	4,079	Employees employed through collective bargaining agreements.
Inclusive salary agreements and personal contracts	1,012	942	Employees employed through personal contracts that are not part of the collective bargaining agreements.
Ranking contracts	264	185	Employees employed through personal contracts under the terms of the collective bargaining agreements for a period of six years on a track that will make them permanent employees.
Age contracts	36	39	Employees who have a right to permanent status after reaching the age of 48. Instead of granting these employees permanent status, they are employed through personal contracts, under the terms of the collective bargaining agreements.
Generation 2000	2,702	3,104	Employees engaged in defined activities, which in the past were staffed by workers from employment agencies. The employment of the employees and their conditions are stipulated in a special collective bargaining agreement for this group.
Temporary	15	18	Employees employed through personal contracts for a period of up to 5 years in a track that will result in permanent status.
Total	8,108	8,454	

2.9.3 Orientation and retirement of employees from January 1, 2005 through December 31, 2005

Employment Framework	Intake	Retirement
Senior Contracts	6	11
Permanent	–	133
Ranking contracts	–	7
Age contracts	–	3
Temporary	–	3
Overall salary contracts	42	62
Generation 2000	643	818
Total	691	1037

2.9.4 Company investment in training

The Company conducts internal training sessions given by professional experts who are Company employees and at times, with the assistance of external organizations, in all its areas of activity. The total number of workdays allocated for training activity for all employees in 2005 was approximately 38,000 days, reflecting an average of 4.5 days of training per employee. This training activity includes, professional training in the fields of technology, sales, management, service and others.

The Company operates a service school that works to instill a service-oriented culture and customer-centric service values, as well as providing knowledge and skills in the provision of excellent customer service.

The Company's total investment in training activity in 2005 amounts to approximately NIS 4.2 million and approximately NIS 1.73 million for higher education.

2.9.5 Nature of employment contracts and streamlining plans

Labor relations at the Company are regulated, in addition to regulations in labor legislation, by the collective bargaining agreements between the Company, the representatives of Company employees and the New General Federation of Labor (hereinafter: "Histadrut") and personal contracts. Additionally, expansion orders to certain general collective bargaining agreements apply to Company employees. These include agreements on cost-of-living allowance.

Under the 1985 collective bargaining agreement, the provisions of the State service articles, agreements, arrangements and work policies which existed or which are mandated by the Ministry of Communications (unless otherwise agreed) apply to Company employees. The national grades for employees in the public service sector and agreements regarding wages, benefits or labor conditions that apply to employees at those grades apply to Company employees, in addition to special collective bargaining agreements. A rights anchoring agreement dated September 4, 2000 (see Section 2.17.4(c) below) provides that all collective bargaining agreements, including arrangements and binding procedures, are to remain in force until December 31, 2006.

It should be noted that in the agreement regarding the sale of the core control of the Company, Ap.Sb.Ar. undertook to act to the best of its ability, by virtue of its holdings in the Company, to ensure that the Company remains in full compliance with all of the collective bargaining agreements, collective bargaining arrangements, current valid and binding practices and personal contracts, subject to the provisions of the law, rights and contractual obligations. Furthermore, even before completion of the transfer of the State's holdings in the Company to Ap.Sb.Ar., a document of principles was signed between Ap.Sb.Ar. and the workers' organization in preparation for a detailed agreement between the Company and the workers' organization (the "document of principles"), which contains reference to changes in the organizational structure of the Company relating to retirement and/or firing of employees, employee rights, reduction of capital whilst maintaining the Company's financial strength, and employee remuneration. As at the date of publication of this report, negotiations have been commenced between management of the Company and the workers' organization regarding these matters.

Following the change in control of the Company, on January 3, 2006, a letter was sent from the Ministry of Finance to the Company confirming that the Company was exempt from the provisions of section 29 of the Elements of the Budget Law (in force as of October 11, 2005, which was the date of transfer of control in the Company from the State to Ap.Sb.Ar.). Upon receipt of the aforesaid exemption, the Company is no longer linked to the public sector in terms of conditions of employment of workers. The Company intends to adopt a wage policy that will accord with the Company's ability and its performances.

For a list of the significant agreements with respect to labor relations, see Section 2.17.4 below.

2.9.6 Employee reward schemes

On November 15, 2005, the Company published an outline of an offer of the State's shares to employees of the Company. The offer is for up to 122,697,648 options, exercisable for up to 122,697,648 shares of the Company held by the State of Israel and constituting approximately 4.71% of the shares in the Company, and exercisable in three equal portions after approximately two years, three years and four years following the date of allotment. In this regard, see Note 1G to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

In addition, in the document of principles set out in clause 2.9.5 above, Ap.Sb.Ar. Undertook to act to sign an agreement stating, *inter alia* and subject to execution of an inclusive agreement under such document of principles, the Company will issue options for the purchase of approximately 4% of the shares in the Company to employees (not including senior management), at a reduced exercise price of 80%.

2.9.7 Company officers and senior executives

As of the date of this periodic report, the Company has 13 directors and 15 senior executives.

The two external directors currently on the board of directors of the Company receive remuneration in accordance with the Companies (Rules Regarding Remuneration and Expenses for External Director) Regulations, 5760-2000. Following the change in control of the Company, and the termination of office of the directors who acted for the Company prior to the transfer of control (with the exception of the external directors), remuneration is no longer paid to directors in accordance with the Government Companies Regulations.

For the management agreement between the Company and a management company held by the shareholders of Ap.Sb.Ar., see Note 27 to the financial statements of the Company for the year ended December 31, 2005, included in this periodic report.

Members of senior management are employed under personal agreements.

2.10 Raw Materials and Suppliers, Purchase of Equipment and Suppliers

2.10.1 The main raw materials used by the Company are: exchanges, copper cable, fiber-optic cables, transmission equipment, data communications systems and equipment, servers, routers and XDSL routers. The Company purchases most of the equipment required for its communications infrastructures from Israeli companies connected with communications equipment manufacturers from around the world. The Company purchases hardware and software from a number of main suppliers. Most of the equipment purchased for data communications, switching, transmission and radio systems is unique equipment, and it is only possible, over the years, to receive support services from the manufacturer.

2.10.2 The following table lists the percentage of Company purchases in 2005 from the main suppliers and the type of contractual arrangement with them:

Main Products	Main Supplier	Type of Contractual Arrangement	% of Purchases out of Total Purchases in Area of Activity
Public switching equipment	Nortel	Framework agreement for purchase, upgrade and maintenance, which was renewed at the end of 2004 until the end of March 2007.	Approximately 6%
Public switching equipment	Alcatel	1. Purchase agreement until the end of 2005. 2. Maintenance agreement that renews each year.	Less than 5%
Billing – computerized billing systems	Amdocs	Framework agreement for the provision of personnel for support, guidance and integration of the systems.	Approximately 5%
Transmission equipment	Supplier D	Framework agreement for purchase and maintenance until the end of March 2006.	Approximately 12%
IP/VPN – IT equipment and integration work	Supplier E	Framework agreement that can be extended each year until the end of October 2010.	Approximately 5%

2.10.3 The Company believes that it is dependant on two suppliers of switching equipment: The Alcatel group, represented in Israel by Alcatel Telecom Israel Ltd. and The Nortel group, represented in Israel by Nortel Israel (sales and marketing) Ltd. In terms of the Company's billing systems for business customers, it is dependant on Amdocs Software Systems.

2.11 Working Capital

2.11.1 The Company's policy is to maintain positive working capital. The cash and cash equivalents component and short-term investments in working capital are generally significant and designed to allow the Company flexibility in its activities.

2.11.2 The inventory purchased by the Company is for the most part intended for investment in fixed assets. The Company's inventory policy strives to maintain an inventory sufficient for its needs for three months, with flexibility for special cases according to the nature of the consumption and price of the item. Orders from suppliers are made taking into consideration past demand and forecasts for the future.

2.11.3 The follow table presents data on supplier and customer credit in 2005:

	Scope of average credit in NIS millions	Average days of credit
Customers	1,026	EOM + 16
Suppliers	484	EOM + 28

2.12 Investments

For information on investments in subsidiaries, see Note 8 to the financial statements for the year ended December 31, 2005, which are included in this periodic report. See also Sections 3 and 4 in Chapter 4 of this periodic report.

2.13 Financing

2.13.1 **Average interest rate on loans**

As at 31 December 2005, the Company is not financed by any short-term loans (less than one year).

The following is a breakdown of the loans from banking and non-banking sources:

Source of financing	Type of currency or linkage	Rate of average interest
Banking sources	CPI linked NIS	4.65%
	Dollar	Libor + 0.62%
Non-banking sources	CPI linked NIS	4.71%
	Euro	6.43%
	Non-linked NIS	Bank of Israel interest + 0.5%

2.13.2 Limitation on receipt of credit

A. With respect to limitations on Company loans – see Notes 13 and 14 to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

B. Limitations imposed by the Bank of Israel regarding individual borrowers and groups of borrowers

Directives issued by the Supervisor of Banks in Israel include provisions according to which the liability of an individual borrower or group of borrowers for a banking institution shall not exceed 15% (individual borrowers) and 30% (group of borrowers) of the banking institution's capital. These provisions further stipulate that total liabilities of the banking institution's six largest borrowers and groups of borrowers shall not exceed 35% of the banking institution's capital. These provisions may, from time to time, affect the ability of some banking institutions to issue additional credit to the Company. However, as a rule, the Company does not have difficulty finding sources of finance. As the Company does not have data and exact information regarding the restrictions on individual borrowers that apply to the banks, and given the fact that the Company cannot quantify a portion of its liabilities to the banks, such as debentures issued by the Company and held by the banks, the Company is not able to estimate when and at what level of debt, if at all, these restrictions will impact on the Company's ability to secure credit.

2.13.3 Credit received during the reporting period

Source of financing	Credit amount NIS millions)	Type of currency or linkage
Debentures	856	CPI-linked NIS

2.13.4 Credit received after December 31, 2005

The Company has not taken any loans since December 31, 2005.

2.13.5 Variable interest

The following table outlines the Company's loans and debentures with variable interest rates (in NIS millions, as at December 31, 2005):

Type of linkage	Change mechanism	Financial scope	Interest range in 2005	Current interest rate
Dollar and dollar-linked	Libor – USD	564	2.13%-4.75%	3.94%-4.75%
Euro and Euro-linked	Libor – EUR 6M	30	2.13%-2.2%	2.13%
Shekel	Bank of Israel interest	36	3.5%-4.1%	4%

Note:

"Interest range" and "current interest rate" are the variable interest rates, not including the spread.

2.13.6 Credit rating

The Company is rated by four credit rating agencies. The following is a list of the ratings of each of the rating agencies:

Rating Agency	Rating	Changes in Rating	Type of Credit Rated
Maalot	AA	March 28, 2005 – AA rating received (no change in rating) May 10, 2005 – rating on watch list, where agency will examine the affect of transfer of control of the Company and the business and financial strategies implemented by the purchase of the core control of the Company on the Company's rating, its conclusions to be published at the end of the examination process.	All series of debentures*
Midrug	Aa1 (Watch List)	March 24, 2005 – Rating changed from Aa1 (Watch List) to Aa1 (Negative). May 16, 2005 – rating moved to Watch List for examination of possibility of downgrading rating.	Debenture series (4) and (5)

Rating Agency	Rating	Changes in Rating	Type of Credit Rated
Standard & Poors	BBB+	May 10, 2005 – rating moved to Creditwatch, with negative implications. October 11, 2005 – rating downgraded to BBB and to remain on Creditwatch, with negative implications. February 28, 2006 – rating remains at BBB+ and rating taken off Creditwatch. Negative rating outlook.	Eurobonds
Moody`s	Baa1	March 7, 2003 – change of rating from A3 (Stable) to A3 (Negative). October 11, 2005 – rating downgraded to Baa1 and kept on review for possible further downgrade. February 6, 2006 – rating left at Baa1 and outlook stable.	Eurobonds and other foreign bonds

* Note: The rating is both for the issuer (the Company) and for the debenture series issued.

2.13.7 Estimate of raising funds in the coming year (2006) and sources of financing

The Company is expected to repay some of its loans in 2006. In order to finance the expected repayment, the Company can use its own sources, raise capital through new loans from banking institutions and/or raise capital on the capital market.

2.13.8 Liens and guarantees

For information regarding the Company's liens and guarantees, see Note 19Cto the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

2.14 Taxation

For information regarding taxation, see Note 11 to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

2.15 Environmental Protection

2.15.1 Regulations on facilities emitting electromagnetic radiation and proposed legislation

The Pharmacists (Radioactive Elements and their Products) Regulations, 5740-1980, regulate, among other issues, electromagnetic radiation from facilities that emit such radiation, and apply to some of the Company's facilities (including wireless communication facilities and the broadcasting stations it operates for the radio and television broadcasting authorities). Establishing such facilities, as stated in the foregoing, and dealing in this, require, *inter alia*, a permit from the Commissioner of Environmental Radiation at the Ministry of the Environment. The Commissioner may make the permit contingent upon certain conditions. Failure to conform to regulations or conditions stipulated in the permit is cause for cancellation or suspension of the permit.

2.15.2 The Non-Ionized Radiation Law, 5766-2006

On January 1, 2006, the Non-Ionized Radiation Law, 5766-2005 (the "**Law**") was published in *Reshumot*, having been passed by the Knesset on December 20, 2005. The commencement of most of the provisions of the Law was set down for one year following publication.

The Law regulates the handling of sources of electromagnetic radiation (hereinafter: "Radiation Source"), the erection and operation of them and supervision of them. *Inter alia*, the Law provides that the erection and operation of a radiation source will require a permit; imposes penal provisions and severe provisions with respect to liability of officers; imposes recording and reporting obligations on a permit-holder and grants the Commissioner for Radiation supervisory powers, including with respect to the conditions of the permit, cancellation of the permit and removal of the Radiation Source. Note that the Company's installations, such as broadcast installations or wireless communication installations, are included under the definition of Radiation Source.

The Law also sets out provisions regarding broadcast installations for cellular communications (hereinafter: "**Cellular Installations**") only, under which regulations are to be made within one year of publication of the Law, regarding safety distances from cellular installations and regarding the procedures for applying for building permits for cellular installations.

The Law includes Amendment No. 75 to the Planning and Building Law, 5725-1965, which provides that a planning institute is to be entitled to demand, as a condition for the grant of permits to erect cellular installations, deeds of indemnity against claims for compensation under section 197 of the Planning and Building Law, 5725-1965, and until provisions are made in this regarding the National Outline Plan, such demand shall be in accordance with the guidelines of the National Planning and Building Council. This provision applies as of the date of publication of the Law.

Further to the aforesaid amendment of the Planning and Building Law, on January 3, 2006, the National Planning and Building Council decided to instruct the local planning committees that, as a condition for the grant of a permit for a cellular installation, they must demand that an applicant for such a permit give a deed of indemnity at a rate of 100% of compensation payments that the committees may be charged with in claims under section 197 of the Planning and Building Law, if so charged, for harm due to the erection of a cellular installation. The form of the deed of indemnity was attached to that decision. The decision is in force until provisions are made in this regard in the National Outline Plan, NOP 36.

For the decision of the National Planning and Building Council of January 3, 2006 regarding the method of amending NOP 36 as aforesaid, see Section 2.16.11(d) below.

The Company is getting ready to adjust its work practices and the licensing of its installations to the provisions of the Law.

For the references in the Law and the implications of the Law to cellular installations, see also 3.18.1.3 below.

2.15.3 With respect to permits for broadcasting installations that are required by the Planning and Building Law, 5725-1965, see Section 2.16.11 below.

2.15.4 With regard to claims filed regarding the Hillel broadcasting station – see Note 19A(8) to the financial statements for the year ended December 31, 2005, which are included in this periodic report.

2.16 Limitations and Regulation of Company Activity

The Company is subject to a series of laws which limit its commercial operations. The main body which supervises the Company's operations as a communications company is the Ministry of Communications.

On April 6, 2005 a letter was sent to the Director General of the Government Companies Authority by the Director General of the Ministry of Communications, containing clarification for the parties that participated in the process of privatizing the Company. As set out in the document, it contained explanations of the main questions raised by the entities that participated in the privatization process, based on the Ministry's present policy of promoting competition in communications and in the provisions of the law and existing licenses, and noted that such should not be grounds for expectation or reliance on the part of the participants.

The main points of the clarifications in the document appear in an immediate report of the Company dated April 11, 2005. As the Company noted in that report, it believes that the clarifications contained in the Ministry of Communications Clarification Document did not significantly reduce the regulatory uncertainty in which the Group and the Company operate. In addition, in the Company's opinion, there has been no progress in a number of issues, the examination of which the Ministry of Communications announced in its clarification document, and it has given notice to the Ministry that these delays are making it difficult for the Company to make preparations for the increasing state of competition.

In this regard, see also Note 1E(1)G to the financial statements of the Company for the period ended December 31, 2005.

2.16.1 Regulation of Company tariffs

The arrangements under Sections 15 through 17 of the Communications Law apply to Company tariffs.

A. During the course of 2005, there were statutory amendments regarding the Company's tariffs, as follows:

1. On April 11, 2005, an amendment to the Communications Law was published under the Economic Policy for Fiscal 2005 (Legislative Amendments) Law 5765-2004, which prescribed a uniform supervision mechanism (tariffs to be set by the Minister of Communications with the consent of the Minister of Finance) regarding the Company's supervised services.

2. This mechanism was set out in Section 15, which provides that "the Minister, with the consent of the Minister of Finance is authorized to determine by regulation the payments for services provided to subscribers by the Licensee." (Hereinabove and hereinafter: the "supervised services").

3. In an Order dated May 31, 2005, the application of the Supervision of Prices of Commodities and Services Law, 5755-1996 was cancelled, having previously applied to part of the supervised services and having prohibited a person from selling a service during the course of his business at a price that is different from the price fixed.

B. The tariffs for the Company's supervised services, stipulated in the aforesaid regulations are updated using a linkage formula, less an efficiency coefficient, as set forth in the regulations and based on the recommendations of public committees for the review of the Company's tariffs.

C. Pursuant to section 15A of the Communications Law, if tariffs are stipulated for the supervised services under the above Section 15, the Minister may, with the consent of the Minister of Finance, approve the request made by the Licensee for an "alternative payment basket" for a package of services.

D. Under Section 17 of the Communications Law, "a Licensee may request a reasonable payment for a telecommunications service for which no payment is stipulated in Section 15." For these types of services provided by the Company (including broadband internet access service, business access, etc.) the Company sets tariffs and informs the Ministry of Communications of them in accordance with its general license. For additional provisions in the general license regarding tariffs, see Section 20.16.2C below.

2.16.2 The Company's general license

The Minister's policy paper

On March 31, 2004 a comprehensive and far-reaching amendment was made to the Company's general license, by virtue of which the Company, *inter alia*, operates. The then Minister of Communications attached a policy paper to said amendment regarding the ability of the Company to offer discounts for size and service packages. On January 9, 2005, non-significant changes were made to the policy paper. The following are the principles of the paper, after its amendment:

Volume discounts - Once a competing domestic operator begins providing commercial telephony services, the Ministry will permit the Company to grant volume discounts of no more than 10% of the payment stipulated for the service, under Section 15 of the Communications Law. Such size discounts will be determined by way of an alternative basket of payments according to Section 15A of the Law. The discount shall not apply to the services for which discounts higher than 10% are set today in the regulations.

Basket of services - Once the market share of the Company in fixed-line domestic telephony in a particular customer segment (business or private) falls below 85%, the Company's license will be amended so as to enable it to submit an application for the Minister's approval to market a basket of services in that customer segment, which includes telecommunications services provided by the Company and by a subsidiary, including broadcasts. The Minister's approval to market a basket of services will be granted, taking into account the status of competition in the area of telecommunications or broadcasts. The Minister's approval shall be given, *inter alia,* with regard to the following: (1) the existence of a bundle of services in a similar format being marketed by a competitor as a package; (2) the Company and the subsidiary enabling customers to purchase any service included in the basket of services separately, on identical terms to those at which the service is offered in the basket; (3) the basket of services being offered to customers on an egalitarian and non-discriminatory basis. If even before the Company's fixed-line telephony market share falls below 85%, a material deterioration occurs in the competitive status of a subsidiary of the Company, stemming from marketing a package of services that includes, among other things, telephony by a competitor, the Minister will consider amending the Company's license as stated above.

In the Company's opinion, the conditions that will enable it to sell joint service bundles with its subsidiaries as set out above, divest such bundles of any content.

In the clarification letter sent by the Ministry of Communications in April 2005 to bidders in the process of privatizing the Company (see preamble to Section 2.16 above), the Ministry stated that the reporting format for measuring market volume would include, as well as the central parameter of revenue, other relevant parameters as well such as numbers of subscribers, lines, call minutes, etc.

On February 22, 2006, the Ministry of Communications notified the Company, HOT and 012 Telecom of its intention to activate a current reporting mechanism, as of May 15, 2006, regarding various parameters on the basis of which the Company's market share would be determined. The Company intends to hold an urgent discussion with the Ministry of Communications in order to clarify issues relating to the method of calculating measurement of the market share, and relief that may be given to the Company upon the loss of such market share. In the Company's opinion, immediate clarification and regulation of these matters are essential if it is to be able to cope with competition.

Highlights of amended license

A. Extent of the license and obligation to provide universal service

The Company is mandated to supply basic services, ancillary and other services as set forth in the appendix to the license; the term of the license is not limited in time; the license anchors the Minister's existing powers under the Law, to modify, revoke and suspend the license; the Company is required to supply its services to all persons, on equal and nondiscriminatory basis with respect to each class of service, regardless of the location or the unique cost. Generally, service that has started to be supplied will be supplied to every party requesting it no later than 12 months after the provision has begun.

B. Rules of structural separation

The Company must establish a structural separation between it and a "subsidiary", the definition of which, for this purpose, includes Pelephone, Bezeq International, BezeqCall Communications, DBS, Bezeq On-line, and GoldNet. (The Minister has the authority to expand the application of the rules of structural separation to an affiliated company[7], if it has been established that there is a real fear of injury to competition or to the public). Full separation between the respective managements of the companies, including all matters relating to the respective business, financial and marketing systems; full separation of the assets; and a prohibition against employing workers of the Company in the subsidiary and workers of the subsidiary in the Company; and also includes a prohibition on the transfer of commercial information to a subsidiary (where the definition of "commercial information" was expanded to include commercial information about the Company). No employee of the Company may be appointed a director of a subsidiary, if, within the scope of his duties in the Company, he has access to "commercial information" concerning a competitor, the use of which by the subsidiary could damage competition between it and the competitor. This limitation on appointment does not apply to the chairman of the board of directors of the Company).

The Company must set rules and procedures to preserve the confidentiality of commercial information on licensees competing with the Company's subsidiary,

[7] Parent company, subsidiary, interested party, affiliated company, related company or partner.

and it is prohibited from transferring said information to the subsidiary. The Company has set such rules.

C. Tariffs

Should the Director General (according to the license: The Director General of the Ministry of Communications or a person authorized by the Minister with respect to licenses in general or with respect to this license in particular, as a rule or for a specific issue) announce that the Minister intends to set a tariff for a new service in accordance with Section 15 of the Communications Law, the Company shall not begin provision of the service before a tariff has been specified, unless the Minister so permits. The Company shall not charge a discriminatory price.

The Company shall provide service or package of services, in respect of which no tariff is stipulated under Sections 15 or 15A of the Law, at a reasonable price, and shall offer them to any person so requesting, without discrimination, at a uniform tariff.

When the Company collects payment for the services of another operator, it shall do so according to its own tariffs without any increment, and the tariffs for calls between the Company's subscribers and those of other domestic carriers, will be uniform and accordingly inclusive.

With respect to charging payment by standing order, credit card, prepayment or the deposit of a security - it was provided that as a rule, the Company shall not be entitled to demand that payment necessarily be made by these methods, with the exception of corporations or subscribers that have not effected payment within 21 days twice during one year. A new subscriber who does not have a bank account may also be required to prepay or deposit a guarantee of up to NIS 200.

D. Investments in other fields and restrictions on cooperation

A provision has been added allowing the Company to invest in any calendar year up to 25% of its annual earnings (not including the income of companies linked to the Company) in activity not designated for provision of the Company's services. The Minister is also entitled to authorize this percentage to be exceeded.

The Company's entering into agreements for performance of services through another licensee requires the Director's approval and contractual arrangements for performance of telecommunications services or telecommunications operations in conjunction with another licensee or broadcasting licensee requires the Minister's approval.

The Company shall not conduct any activity and shall not be party to any agreement, arrangement or understanding which is designed or which might limit or harm competition in the field of telecommunications. The Minister may direct the Company on the steps to be taken in order to prevent harm to competition in the field of telecommunications or broadcasting.

E. Numbering and number portability

For the numbering plan and number portability, see Section 2.6.5A above.

F. Operation of Company networks and service levels

The Company must maintain and operate the network and provide its services 365 days a year, around the clock, including at times of emergency, in a regular and proper manner, commensurate with technical requirements and service quality. The Company is also bound to work towards improving its services.

G. Interconnectivity and use

Infrastructure services - the Company will supply such services to another licensee such that it will be to meet the requirements of its license, under reasonable and non-discriminatory conditions, avoiding preference in favor of a licensee that is an affiliated company. New provisions have been made regarding provision of essential information which another licensee may need in order to receive service from the Company, and in order to supply services so as to enable it to meet the service level requirements imposed upon it and so as not to discriminate between recipients of the Company’s services and the other licensee’s customers.

Note that the cover letter attached to the amendment of the Company's general license explained that the provision in the license dealing with provision by the Company of infrastructure services does not constitute a concrete provision regarding use by communications carriers of the Company's infrastructure segments (unbundling).

Interconnectivity - new provisions were included which are essentially designed to enable the implementation of interconnectivity between the Company's network and that of another public network. Similar provisions exist with respect to providing the option of use to another licensee.

With respect to the dispute between the Company and Cellcom on payment of interconnectivity fee, see Note 1E(2)A to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

H. Arrangements in the field of security

Provisions were included for operation of the network in times of emergency. The Company is to set up and operate its network in a manner which will prevent its collapse at the time of emergencies and enable a reduction of activity in certain sectors.

The Company is to perform telecommunications services and set up and maintain the end equipment infrastructure for the security forces in Israel and abroad, as provided in agreements with the security forces. The Company will further supply special services to the security forces as set out in an appendix, which is top secret. The Company will take action to ensure that each purchase and installation of hardware in its telecommunications installations, except for end equipment, will be made in full compliance with instructions that are given to the Company according to Section 13 of the Law.

The Company shall appoint a security director and fully comply with the security instructions contained in the appendix to the license (Israeli requirements, security clearance for the appointment of certain officers, nondisclosure of classified information, including to a shareholder, if the revelation contradicts the security provisions, board meetings discussing security issues, guarding secrecy, protecting systems and limiting reporting or publication pertaining to the provision of classified service to the security forces).

For the Bill to amend Section 13 of the Communications Law so that the prisons service be included as part of the security forces, and to add section 13A to the Communications Law dealing with the power of the Minister of Communications to instruct a licensee in terms of emergency, see Section 2.16.12 below.

I. Liability and insurance

Detailed provisions have been added regarding the obligation to insure the Company's liability.

J. Control and reporting

Wide-ranging reporting duties have been imposed on the Company, such as filing the reports specified in the license and on-demand reports on various matters.

The Director has also been granted authority to enter facilities and offices used by the Company, and to inspect and copy documents and demand information and reports from the Company.

K. Miscellaneous matters

The general license includes "cross-ownership" restrictions.

Neither the license nor any part thereof is transferable, or may be made subject to a charge or lien.

Under the amendment to the license, the Company is to prepare a draft contract it intends to offer to subscribers, and shall submit such to the director for review, upon the demand of the latter. The Director shall have the authority to order changes. The Company is in the process of preparing said contract.

The Company must provide a bank guarantee to secure performance of the license conditions and indemnify the State for any damage that may be incurred by it following the breach thereof, such guarantee to be in an amount equal to US$10 million. The Company has furnished the guarantee as required.

Under the provisions of the Law, the Minister of Communications has the authority, at any time, to revoke, limit or suspend a license, if, for among other reasons, performance of telecommunications activity or provision of telecommunications services by a Licensee do not conform with the standard and at a proper level of similar activity or service, in accordance with the rules stipulated in the Law, or if the Licensee is in material breach of the terms of the license.

The Director General of the Ministry of Communications is authorized to impose a monetary sanction on breach of any of the terms of the license.

On December 23, 2004, the Ministry of Communications amended the Erotic Services Appendix to the Company's license, and the definition of "erotic service" was expanded in the licenses of the cellular operators. The meaning of a service being defined as an erotic service is that it is being subject to rules determined by the Ministry in this matter, including requirements for blocking. On June 8, 2005, the Ministry of Communications provided a draft appendix to the general licenses to the cellular licensees, HOT and the Company, for remarks, regarding replacement of the "erotic services" appendix with "adult services". Under the draft appendix, a variety of services that are not appropriate for minors, due to their nature and substance, will be regulated by way of use of access code 1919, instead of what the Ministry sees as the restricted arrangement of "erotic services". The proposed amendment extends the content that may be offered via the aforesaid prefix to all "adult services" such as introductions, chats, matchmaking, etc., and prescribes clear rules for "reliable identification" of an adult prior to removal of the block. The Company, without going into the main body of the matter, asked that the requirement to play a voice message to all subscribers blocked from the service not apply to a licensee which does not itself produce the service, since the technology by which the Company currently provides access to the service, and which was adopted based on the previous amendment to the license, does not enable this.

On December 30, 2004, the Ministry of Communications began a process of amendments across all general licenses. The goal is to make the provisions and wording of similar sections in all general licenses uniform, as there is no real justification for the differences between them. As a rule, in terms of the Company, this consists of a small number of revisions which are not significant compared to the existing license.

On July 14, 2005, the Company's general license and the licenses of other operators were amended. The amendment to the license prescribed that the Company must act in accordance with the Israeli Standard regarding reliability of bills and due disclosure in telephone accounts. In addition, provisions that are different from those in the aforesaid standard were prescribed regarding rounding off of sums in bills. Under the amendment, the provisions of the standard regarding due disclosure in telephone bills will come into force by October 14, 2005, whilst provisions relating to reliability of billing will come into force by January 14, 2006. The Company's license was amended in this manner, despite the fact that the Company expressed its opinion to the Ministry that there is no room or justification for the standard in its proposed format, and certainly not for changing it, by adopting it in the license, into a binding standard, bypassing the statutory mechanism set out in the Standards Law. Likewise, the Company clarified that implementation of the standard involves investment of considerable resources, technical difficulties and the effecting of broad based changes to core systems, which cannot be done at the same time as implementation of the number portability program, and that it needs a longer period of time to implement the standard. The Company is prepared to implement the standard in accordance with the amendment of its license, however, at the same time, it contacted the Ministry of Communications and gave notice to it that it would not be able to meet the dates set out for implementation of the standard under the amendment of the license, and asked that the matter be presented to the Ministry in order that the Company's request for a longer preparation period may be re-examined. On October 16, 2005, the Director General of the Ministry of Communications notified the general licensees, including the Company, that in light of the importance of the matter to consumers, there would be no delays in implementation of due disclosure. In this regard, on November 28, 2005, the Company once again gave notice to the

Ministry that the components required under the standard appear in the bill issued by the Company, with the exception of one particular component, which shall be supplemented upon completion of development of the Company's billing system, within about a year, as it had warned prior to amendment of the license, due to technological realities and specific difficulties. In the interim period, until completion of such, the Company publishes its principal call tariffs in a prominent manner which, in its opinion, causes it to be in compliance with the purpose of the standard.

2.16.3 Royalties

The Communications Law stipulates that Licensees for the provision of telecommunications services shall pay royalties to the State of Israel on its revenues from the provisions of telecommunications services at a rate to be determined by the Minister of Communications and the Minister of Finance and approved by the Knesset Finance Committee. The rate of royalties stipulated in the Law is 11%, but the provisions allow other rates to be stipulated.

The regulations that entered into effect on January 1, 2001, Telecommunications (Royalties) Regulations 5761-2001 (hereinafter: the "Royalties Regulations"), expanded the revenue base on which royalties must be paid, while at the same time gradually reducing the rates. Under the regulations, any party that received a general telecommunications license for the provision of fixed-line domestic services (including the Company), international telecommunications services and cellular services must pay royalties on revenues (without VAT) from the subscriber services in the Schedule to the regulations, including revenues from these services in Judea, Samaria and the Gaza Strip (except for areas in the Palestinian Territory) and including revenues from the provision of these services to the security forces under Section 13 of the Law. The revenues on which royalties must be paid as stipulated in the Schedules are as follows: For a Licensee providing fixed-line domestic telecommunications services (including the Company) – from January 1, 2004 – 3.5% on all revenues from the provision of telecommunications services that are attributable to charges of recipients of the Licensee's services, less revenues collected for another Licensee or which were transferred to another Licensee, or payments made to another general Licensee for completion of calls or their transfer on its telecommunications network, and less revenues from the provision of transmission service to other Licensees, revenues from a segment of transmission service via satellite, revenues from the sale of terminal equipment and bad debts related to revenues on which royalties must be paid.

From time to time, a dispute over royalties arises between the Ministry of Communications and the Company. Thus, for instance, from April 1999 through to the end of 2000, the Company did not pay royalties on its revenues from interconnectivity from cellular subscribers to Company subscribers, as it claimed that the regulations regarding royalties that were in effect at that time did not apply to these revenues. The Ministry of Communications announced that it viewed the Company's refusal to pay said royalties as a breach of the provisions of the Royalties Regulations and of the provisions of the general licenses and asked the Company to reconsider its position and transfer a total of approximately NIS 17 million to the Ministry by January 1, 2005. The Company replied to the Ministry of Communications that it maintained its legal stance and that the Ministry had not given reasons for its decision, and had not responded to the claims and data presented in this regard by the Company to professional staff at the Ministry. The Company also requested an urgent meeting with the Director General of the Ministry of Communications regarding this matter, and that the payment demand be stayed until such meeting is held. On February 19, 2006, the Ministry of Communications' response was sent to the Company stating that the Ministry of Communications sees no reason to hold additional discussions on the matter and asking that the Company provide it immediately with the royalty payments as aforesaid. In this regard, see also Note 19A(20) to the Company's financial statements for the year ended December 31, 2005, included in this periodic report.

With respect to the amendment of the Royalties Regulations regarding compensation for the "Bill and Hold" arrangement with HOT, see Note 1E(1)D to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

The Economic Policy Law, published on April 11, 2005, imposes license fees and royalties to the collection of fees under the Communications Law and The Wireless

Telegraph Ordinance (New Version) 5732-1972 (hereinafter: the "Telegraph Ordinance") and the Tax Ordinance (Collection) 1929. The significance of the amendment is the addition of a means of enforcing said payments.

On May 2, 2005, the Company received a copy of a letter dated April 20, 2005 sent by the Director General of the Ministry of Communications and the Deputy Supervisor of Budgets at the Ministry of Finance to the Director General of the Government Companies Authority, setting out the position of the Ministries of Communications and Finance on the matter of the obligation of the holders of international telecommunications licenses and of fixed-line domestic telecommunications licenses to pay royalties. According to the letter, following the recommendations of the committee for formulating policy and rules for opening fixed-line communications to competition, against the background of the proceeding for sale of the State's Holdings in the Company and as part of the preparations for the implementation of the number portability service throughout the entire telecommunications sector, the Telecommunications (Royalties) Regulations are to be amended by the Ministries and brought for the approval of the Minister of Communications, the Minister of Finance and the Knesset Finance Committee, as required by law, so that commencing January 1, 2006, a reduction of 0.5% will be made each year in the rate of the royalties paid by those licensees until reaching a rate of 1% in 2010. As at the date of publication of this report, the Regulations have not yet been made. On December 22, 2005, the Company sent a letter in this regard to the Director General of the Ministry of Communications and to the Commissioner for Budgets at the Ministry of Finance, asking for them to intervene in the immediate application of the aforesaid amendment, so that the date of determination for commencement of the gradual reduction of the rate of royalties would be January 1, 2006, as required. The Company is also waiting for an amendment to the Royalties Regulations to the effect that an exemption be given, as of January 1, 2004, from payment of royalties for revenue from certain data communications services under competition, as the State had undertaken to the Court in a hearing of the petition submitted by the Company against it.

2.16.4 Authority with respect to real estate

According to the provisions of Section 4(F) of the Communications Law, the Minister of Communications granted the Company certain powers in connection with real estate, as set out in Chapter Six of the Law. Until the Law was amended in 2001, this Chapter did not distinguish between public and private land, and enabled the Company and the persons it authorized for purposes of providing telecommunications services, to enter any real estate in order to carry out surveys and examinations required for planning a telecommunication installation, and for examining, repairing or making changes thereto or therein. In most cases, prior notice was required to be given to the occupier of the real estate and the latter could appeal to the Court.

Amendment No. 25 of the Law, of 2001, distinguished between land owned by the State, the Development Authority, the Jewish National Fund, a local authority or corporation established by law and which was owned by one of them, and a road (hereinafter: "Public Land") and other land (hereinafter: "Private Land"). With respect to public land, the Company and any person authorized by it, may enter and perform work on the land, provided that approval for deployment of the network has been granted by the local planning and building committee. The local committee must decide on a request to approve such a plan within 60 days of it being filed, and in the absence of a decision, the plan will be deemed to have been approved. In most cases, it is necessary to give the occupier 21 days' advance notice and the latter may appeal to the Court.

Deployment of a network on private land requires the consent of the landowner or the long-term lessee or protected tenant, depending on the circumstances. In a condominium, the consent of a majority of the apartment owners is required. Notwithstanding the above, the Law contains provisions regarding the deployment of a network in a condominium at the request of an apartment-owner, even in the absence of the consent of a majority of the apartment-owners, while providing powers to the condominium committee and the Condominium Inspector.

2.16.5 <u>Immunities</u>

The Minister of Communications granted the Company certain immunities as listed in Chapter Nine of the Law, pursuant to his authority to grant immunity to a general license holder.

A Licensee granted immunities according to Chapter Nine of the Law (hereinafter: an "Immune Licensee"), its employees and all persons acting on its behalf shall not bear liability in tort, except:

(1) For direct damage caused by the restriction or discontinuance of a telecommunications service;

(2) For damage arising out of an intentional act or gross negligence of the Immune Licensee, its employees or persons acting on its behalf.

Under the Communications Law, an Immune Licensee, its employees and all persons acting on its behalf shall not bear liability for damage caused:

(1) By non-provision, delay, restriction or discontinuance of telecommunications services and accessory services as arises out of an intentional act of the Immune Licensee insofar as such act is necessary to the performance of a telecommunication operation or the provision of a telecommunications service;

(2) By an error in providing a telecommunications service, an error or omission in a telecommunications message, non-delivery of or a delay in delivering a communication message, delivery of a telecommunication message to a wrong address or an incorrect entry in a subscribers' directory or other publication of the licensee, unless the same is due to gross negligence.

Under Section 13 of the Law which relates to the provision of telecommunications services to the security forces, a licensee or any of its employees shall bear no criminal or civil liability for any act committed in the performance of a direction to be given according to said Section, except in circumstances in which the State employee bore liability for the act. (Under the Civil Wrongs Ordinance, in any action other than negligence, a public servant will have a defense if the act was within the lawful field of their authority or was committed by him in good faith and he understands that he was acting within the scope of his lawful authority).

2.16.6 <u>Regulations and rules under the Communications Law</u>

As at the date of this periodic report, regulations in three main additional areas apply to the Company: (1) the termination, delay or restriction of a telecommunications operation or service; (2) installation, operation and maintenance; (3) methods of inspecting the acts of the Licensee; in addition to which the Company, with the Ministers' approval, sets rules regarding the Company's services to subscribers.

The regulations and rules mentioned above regulate the conditions on which the Company may disconnect, discontinue and renew the service at or without the subscriber's request, terminate a service, connect another subscriber to the telephone line of an existing subscriber, and remove telecommunication installations. In addition, the regulations regulate the Company's powers and duties, as well as the rights and obligations of each subscriber. The regulations also regulate the provision of information and entertainment services over the Company's network.

According to the regulations, the Company shall provide its subscribers with the telecommunications services listed in the general license, in a proper and regular manner.

The Company may, with the consent of the Minister, terminate, disconnect or limit the provision of a telecommunications service if the service becomes outdated on technological grounds, or if the service is abused in such a way as to cause tangible financial harm to the public or a part of it, or to the Licensee. Pursuant to the regulations regarding methods of supervision of the acts of a Licensee, the Minister of Communications appointed a manager (an employee of the Ministry) authorized, *inter alia*, to ensure adherence to the provisions of the Communications Law, the regulations and license, for the classes of telecommunications services and conditions thereof, quality of such services and level of maintenance.

In addition, provisions exist regarding reporting, according to which every Licensee must file periodic reports and reports of special events. Rules regarding the Company's services contain provisions relating, *inter alia*, to the issue of bills to subscribers, charging in installments, an appeal committee for complaints regarding charges, and the publication of an entry in the subscriber directory.

The Company acts to locate debtors and to collect debts from its customers. In cases where debts are not paid, legal action is usually taken through external lawyers. In cases such as when it is not financially feasible the debt is written off.

According to the regulations, the Company may disconnect a line if the bill in respect thereof is not paid within 21 days of the payment date prescribed in the bill, and discontinue the service if prior written notice thereof has been given.

On November 22, 2004, draft regulations were submitted for the review of the Company, HOT, and cellular license holders. These were for the establishment of a committee made up of representatives of the public to examine requests for exemption or exception from the provisions stipulated in the regulations or in the general licenses for the provision of services by the Licensee to the entire public. The Company submitted its response to the Ministry and, among other things, requested that an exemption or exception based on the existence of available alternatives in a region for provision of service be subject to the obligation of the Licensee whose request was successful to participate in the costs of financing of a Licensee that provides services in that region.

2.16.7 Antitrust laws

A. On June 27, 1995, the Antitrust Commissioner (hereinafter: the "Commissioner") declared the Company to be a monopoly in the following areas: Basic telephone services, provision of communication infrastructure services, unlimited bi-directional international telephone services (including service for incoming calls) and transfer and transmission broadcasting services to the public.

   The Commissioner's declaration of the Company as a monopoly constitutes *prima facie* evidence of the terms thereof in any legal proceeding, including criminal proceedings. Therefore, a plaintiff - being a person or consumer organization - who seeks to sue the Company - or a subsidiary of the Company, in appropriate cases - either by a personal civil action or class action will be excused from proving the fact that the Company is a monopoly, to the extent this proof is relevant for its claim, in reliance on the Commissioner's declaration, and the Company will have to discharge the burden of proof in rebutting the contents of the Commissioner's declaration in this respect.

B. At the end of 1995, the Company transferred its activity in the field of provision of international telephone services to Bezeq International and as a result, Bezeq International "inherited" the Company's monopolistic position in this market. On April 29, 2001, the Commissioner decided to cancel the declaration of Bezeq International as a monopolist in the field of provision of international telephone services, due to the competition that had emerged in this market.

C. In light of the changes and developments which have occurred in the communications market overall, and particularly in the field of "basic telephone services", especially in light of the increasing competition in the field of this service compared with the cellular telephone companies, the Company applied to the Commissioner on March 6, 2000, requesting the cancellation of his declaration of the Company as a monopoly in the field of "basic telephone services".

   The Company filed an appeal on September 9, 2001 against the Commissioner's decision not to cancel said declaration. As at the date of this periodic report, the issue is pending before the Antitrust Tribunal.

D. On December 11, 2000, the Commissioner declared the Company a monopoly in the field of "telecommunications infrastructure for the provision of high-speed access services via internet service providers". On January 10, 2001, the Company filed an appeal against this declaration.

   On November 10, 2004 the Commissioner announced that he had decided to split the existing declaration into two separate declarations:

(1) Provision of fast access services to subscribers through the access network.

(2) Provision of fast access services to ISPs through a central public telecommunications network.

As a result and following the changes in the relevant marketplaces since the declaration, Bezeq notified the Court on November 17, 2004 that it wanted to withdraw the aforementioned appeal, and on November 18, 2004, the appeal was expunged.

E. On August 26, 2004, the Commissioner approved the merger between Pelephone and the company (following the acquisition of Shamrock's share of Pelephone by the Company) under conditions that limit joint activity and transfer of commercial information as defined in said conditions.

Since September 1998, the Company employs an officer to oversee internal compliance with the Antitrust Law, 5748-1988 (hereinafter: the “Antitrust Law”).

The Company has adopted an internal compliance policy (hereinafter: the “Policy”) containing internal reporting and internal procedures which essentially ensured that the activity of the Company and its employees would be carried out in accordance with the provisions of the Antitrust Law. The Policy includes a general explanation regarding the Antitrust Law, guidelines for the Company's and its employees' conduct so as not to breach the provisions of the Antitrust Law. Under the Policy, the internal compliance officer issues, from time to time, general and specific directives on various issues (such as pricing, relations with subsidiaries, contacts with customers and the like). The internal compliance officer's directives bind all of the Company's employees and managers.

2.16.8 The Wireless Telegraph Ordinance

The Telegraph Ordinance regulates the use of the electromagnetic spectrum, and applies, *inter alia*, to the Company’s use of radio frequencies, as part of its infrastructure. The set-up and operation of a system making use of radio frequencies is subject, under the Telegraph Ordinance, to the issue of a license, and the use of radio frequencies is subject to designation and allocation of a suitable frequency. The Telegraph Ordinance imposes license fees and fees for designation and allocation of frequencies.

For a number of years, the Government has been dealing with a shortage of radio frequencies for public use in Israel (among other reasons, due to the allocation of a large number of frequencies for security purposes), by limiting the number of licenses granted for the use of frequencies on the one hand, and increasing the fees payable for allocation of a frequency in the lower range, on the other.

The frequency fees were raised in 1999, some by very high rates.

The Company and the Ministry of Communications have a number of differences of opinion regarding fees which the Company claims it does not owe and therefore has not paid. As at the date of this periodic report, the disputed amounts are approximately NIS 42 million (appropriate provisions have been included in the financial statements).

2.16.9 Proposed legislation regarding termination of contractual relations

In 2005, the Knesset Economics Committee discussed a private member’s bill to amend the Consumer Protection Law, which intervenes in the contractual relations between a person dealing in defined deals and the consumer. Under the Bill, a contract will be deemed to provide that it will be rescinded unless the dealer offers the customer to extend the term of the contract and the customer agrees to such.

As drafted in the Bill, this provision will not apply to special offers for up to six months and transactions that will be stipulated in a Schedule to the Law. These transactions have yet to be defined, but the intention, as stated in the discussion of the Economics Committee, is to stipulate in the Schedule those types of transactions which, if rescinded unilaterally, could cause injury to the consumer, such as a basic telephony service.

2.16.10 Bill regarding class actions

The Knesset is currently in the process of legislating regarding class actions, as part of a government bill and a private member's bill. The above Bills cancel the individual causes of action for filing class actions set out in individual laws, expand the possibility of filing class actions greatly, and it is the Company's position that they do not impose appropriate barriers that might enable the filtering required to prevent wasting of resources caused by sham claims. The Company and other entities have contacted the chairman of the Constitution, Legislation and Justice Committee and the Speaker of the Knesset and have expressed their opinion that the drafts of the above Law are severely harmful to potential defendants and might expose all of the large commercial bodies in Israel to unnecessary claims of immense size, thereby shaking the foundations of the entire economy.

2.16.11 Establishment of communications installations - National Outline Plan 36

A. The National Outline Plan for Communications, NOP 36, was designed to regulate the deployment and method of establishing communications installations to secure their functioning throughout the entire country, for radio broadcasting and reception, television and wireless communication, while minimizing harm to the environment and the landscape.

B. NOP 36A

Part I of NOP 36 (NOP 36A), dealing with the issue of building permits for small and micro-broadcasting installations, was approved by the Government on May 2, 2002.

A transitional provision contained in NOP 36A stipulates that: (1) a building permit or exemption from a permit that has been issued for a broadcasting installation and not in accordance with the provisions of NOP 36A, will be regarded as irregular use that has been permitted for a period of 18 months commencing from the date of the approval of NOP 36A; If the operator of the installation submits to the institution that approved the erection of the installation, within said period, a permit from the Commissioner for Radiation regarding compliance with the safety restrictions stipulated in the Plan, the permit or the exemption from the permit will be regarded as permitted irregular use. Otherwise, the permit or exemption will expire. (2) A permit issued within two years of the date NOP 36A was approved for broadcasting installations erected prior to January 1, 1989, shall not be deemed as conflicting with NOP 36A, provided it meets the safety restrictions stipulated in the Plan.

As of the date of this periodic report, the Company has submitted a permit from the Commissioner on Radiation regarding all of the 74 small broadcasting installations erected under a permit issued prior to the approval of NOP 36A to the relevant licensing authorities, building permits have been obtained for 51 other broadcasting installations in accordance with NOP 36A, and the Company is working to receive permits from the relevant licensing authorities for a further 23 small broadcasting installations. Due to intensive activities being done at the Company regarding the obtaining of permits, and due to the termination of operation of certain installations, the number and class of sites change from time to time.

Given the provisions of the Planning and Building Law, 5725-1965 and the provisions of the Communications Law, the Company believes that the obligation to be issued building permits for micro-broadcasting installations, which are "wireless access facilities" do not apply to it under said laws.

C. NOP 36B

Part B of the Plan (NOP 36B) applies to all types of broadcasting installations, except for those included under NOP 36A. The licensing process proposed under NOP 36B requires the preparation of a detailed plan (except in unusual cases) and the receipt of the necessary approvals which are also required under NOP 36A.

NOP 36B proposes transitional provisions under which: (1) a building permit issued for a broadcasting installation according to a previous plan which does not comply with the provisions of the NOP 36B, shall be regarded as irregular use that was permitted for a period of 24 months from the date of the approval of the Plan. If the operator of the installation submits to the institution that approved the erection of the installation, a permit from the Commissioner on Radiation of compliance with the safety restrictions prescribed in the Plan, within said period, the permit will be regarded as being in compliance with the provisions of NOP 36B. Otherwise the building permit shall expire. (2) A permit may be granted for broadcasting installations erected prior to the approval of the NOP 36B at a broadcasting site which existed prior to January 31, 1984, even if the installations do not comply with the provisions of the NOP 36B, provided they meet the safety restrictions specified in NOP 36B.

The Company's broadcasting installations included in NOP 36B were for the most part built many years ago, some by State authorities.

NOP 36B further proposes to include a provision according to which a building permit will not be granted according to Chapters C and D of the Plan, unless the applicant for the permit has submitted a letter of indemnity for compensation under Section 197 of the Planning and Building Law, should a judgment go against the local committee. The Company has submitted its objection to the inclusion of said provision in NOP 36B.

D. General

For Amendment No. 75 of the Planning and Building Law, 5725-1965, which includes a requirement to deposit deeds of indemnity for cellular communications broadcast installations, and the decision of the National Building and Planning Council of January 3, 2006 given in respect thereto, see Section 2.15.2 above, and sections 3.18.1.3 and 3.18.3.3 below.

The decision of the National Planning and Building Council of January 3, 2006 also provided that a committee of drafters of the NOP, in a new composition which has been prescribed, would examine the recommendations of the committee of directors general of the relevant government Ministries, regarding the deployment of cellular broadcasting installations under NOP 36A, with reference to the issue of indemnity, would recommend the making of amendments to the issue of the deed of indemnity under NOP 36A, and the decision that it comes to regarding indemnity would apply, *mutatis mutandis*, to NOP 36B as well.

E. With respect to radiation permits for broadcasting installations, see section 2.15 above.

2.16.12 Bill to amend Section 13 of the Communications Law

On November 22, 2005, the Ministry of Communications sent general licenses, for their comments, a bill to amend Section 13 to the effect that the prisons service be included as part of the security forces, and to add a Section 13A to the Communications Law regarding the power of the Minister of Communications to give instructions to a licensee during emergencies. This comes after a discussion in the Economics Committee of the Knesset, held after the Bill had passed first reading. On November 24, 2005, the Company provided the Minister of Communications with its comments, to the effect, *inter alia*, that extreme situations and other situations included in the definition of "emergency" should be distinguished, that the licensees should be heard and that the provisions regarding payments as a result of performance of the provisions should be amended.

2.17 Substantial Agreements

The following is a summarized description of the substantial agreements that are not part of the Company's ordinary course of business, and that were signed and/or were in force during the period of this periodic report:

2.17.1 **Debentures**

A. Deed of trust for debentures (series 4) dated May 24, 2004

A deed of trust for a series of 1,200,000,000 debentures of NIS 1 par value each, repayable in four equal annual installments on June 1 of each of the years 2008 to 2011, bearing annual interest of 4.8%, linked (principal and interest) to the CPI for April 2004. Of these, 800,000,000 Debentures were to the public by prospectus (hereinafter: the "Prospectus") on May 24, 2004 and 400,000,000 were purchased by a wholly owned and controlled subsidiary of the Company, Bezeq Zahav (Holdings) Ltd. (hereinafter: "Bezeq Zahav Holdings") immediately prior to the Prospectus and were listed for trade according to the Prospectus.

B. Deed of trust for debentures (series 5) dated May 24, 2004 and an addendum to this deed dated December 6, 2004

A deed of trust for a series of 600,000,000 debentures of NIS 1 par value each, repayable in six equal annual installments on June 1 of each of the years 2011 to 2016, bearing annual interest of 5.3%, linked (principal and interest) to the CPI for April 2004. The debentures were issued prior to the Prospectus to institutional investors and to Bezeq Zahav Holdings and listed for trade according to the Prospectus.

An addendum to the deed of trust for the debentures in this series relates to the issue of an additional 1,500,000,000 debentures which were issued by the Company to Bezeq Zahav Holdings under the same conditions and listed for trade on the stock exchange (subject to lock-up restrictions).

On March 30, 2005, another addendum to this deed of trust was signed between the Company and the Bank Mizrahi Trust Company Ltd. for the issue of NIS 286,967,000 par value debentures in the same series.

C. Series of agreements regarding raising capital through the issue of debentures (Eurobonds) on the Luxembourg Stock Exchange

A series of agreements (including debentures) related to the issue of Company debentures on August 8, 2000 on the Luxembourg Stock Exchange – a series of 300 million euros par value 7-year debentures (as part of a total of up to 750 million euros as part of the EMTN Program). The debentures bear interest of 6.5% per annum. The interest is paid in annual installments, on August 8 each year, from August 8, 2001 through August 8, 2007.

2.17.2 **Real Estate**

A. Asset transfer agreement between the Company and the State dated January 31, 1984

An agreement between the State and the Company, under which the Company was conferred the State's rights in assets which the Ministry of Communications used for providing telecommunication services, and the Company assumes the rights of the State with respect to those assets and the obligations and liabilities with respect to these rights immediately prior to implementation of the Agreement. Moreover, under that Agreement, the State's rights, powers, obligations and duties according to the agreements, contracts and transactions that were in force with respect to telecommunications services immediately prior to implementation of the Agreement, were transferred to the Company.

B. Settlement agreement between the Company, State and Israel Lands Administration regarding rights related to land, dated May 15, 2003

See Section 2.7.4C above.

C. Agreement between the Company and the Israel Postal Authority

An agreement dated June 30, 2004 between the Company and the Israel Postal Authority to define and arrange the rights of the Company and the Postal Authority to their joint assets. The agreement listed the joint assets and defined the share each party has in them. It was determined that each of the parties shall have exclusive rights to their share, except with regard to rights in joint assets, building rights or rights that have been explicitly clarified elsewhere. With regard to a number of additional assets, the party with exclusive rights to them, in whole, will be one party that was so determined.

2.17.3 **Various agreements with DBS and its other shareholders**

A. On December 4, 1998, the founders of DBS – the Company, Eurocom Communications Ltd., Lidan Business Enterprise Ltd. and Gilat Communications Ltd., entered into a Founders Agreement, which regulates the establishment, management and relationship between the shareholders of DBS.

B. An agreement dated December 30, 1998 between the shareholders of DBS, stipulated the establishment of an executive committee and its authorities.

C. In November 2001, an agreement was signed between the shareholders (except for Gilat) and DBS, amending the dilution formula stipulated in the Founders Agreement and determined that the holdings of the shareholders be adjusted to their proportionate holdings in DBS, such that for the purpose of dilution, the investments (effected by way of shareholders loans) would bear CPI linkage differentials and annual compound interest at a rate of 5.5% per annum from the date of incorporation of DBS.

D. An agreement dated December 30, 2002 between DBS shareholders and DBS determines preference for shareholder loans given as of July 10, 2002 over the loans made prior to that date, and that these loans would bear CPI linkage differentials and annual linked compound interest at a rate of 5.5%, and an amendment to the agreement dated August 6, 2003 which stipulated an interest rate of 11% for new loans granted as of April 27, 2003.

2.17.4 **Labor agreements**

A. A comprehensive pension agreement was executed on September 21, 1989 between the Company, the Histadrut and the joint representation of the workers' committees and Makefet Fund – Center for Pensions and Remuneration Cooperative Society Ltd.

The agreement provided a full and autonomous arrangement regarding the pension insurance of Company employees. The agreement applies to all transferred employees (who were transferred from the Ministry of Communications to the Company), to all of the members of the cumulative pension fund employed by the Company on the date of execution of the pension agreement and to all of the permanent and temporary employees of the Company, with the exception of special employee groups (students, employees under personal contracts or employees under some other alternative arrangement).

B. Special collective bargaining agreement for early retirement, dated November 23, 1997 as amended and extended on September 4, 2000, March 18, 2004, April 17, 2005 and June 28, 2005 between the Company, the Histadrut and the Workers' Organization

For information regarding this agreement, see Note 16D(1) to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

C. Agreement to anchor rights, dated September 4, 2000 between the Company, the Histadrut and the Workers Organization

A special collective bargaining agreement executed between the Company, the Histadrut and the Workers Committee, *inter alia* regarding anchoring the rights of the transferred employees. This agreement was intended to anchor the rights of the transferred employees to the pension rights to which they were entitled by virtue of their being former public servants, under the Company's pension agreement, adopted by the Company under its pension agreement. According to this agreement, these rights became "personal rights" which could not be cancelled, other than by waiver of personal rights under law (i.e., by personal waiver by the employee himself or herself).

For this, see also Section 2.9.5 above.

D. "Generation 2000" agreement, executed on January 11, 2001 between the Company, the Histadrut and the Workers Organization

Following an amendment in July 2000 to the Employment of Employees by Human Resources Contractors (Amendment) Law, 5760-2000, a special collective bargaining agreement was signed between the Company, the Histadrut and the Workers Committee on January 11, 2001 to recruit new employees and stipulate their salary conditions. The agreement applies to new employees and to employees who were previously employed at the Company via human resources companies, in positions listed in the appendix to the agreement (customer service representatives at call centers, administrative workers, typists, warehouse employees, secretaries, mail sorters and distributors etc., administrative employees such as porters, drivers and forklift operators, and others).

Employees are to be employed under this agreement for a period of no more than 6 years, with an option to extend the agreement for a period of two further years.

E. Agreements regarding 'encouragement of growth' (May 22, 2003 and May 3, 2005)

On July 29, 2003, the Company notified the Commissioner for Salaries and Human Resources at the Government Companies Authority that the Company was joining the collective bargaining agreement dated May 22, 2003, executed by the State, the Union of Local Authorities and others and the Histadrut with respect to encouraging growth. Under the agreement, Government and public sector expenditures would be cut in accordance with legislation on this matter. Under the agreement, wages of Company employees were reduced in the period following July 2003.

On May 3, 2005, a special collective bargaining agreement was executed between the Company, the Workers' Organization and the Histadrut. Under that agreement, a one-time grant was paid to employees of the Company after completion of the sale of the State's holdings in the Company, in the amount of part of the sum of the reduction of wages under the Israeli Economy Recovery Plan Law, and under the collective bargaining agreement to encourage growth in the economy.

F. Contract dated April 17, 2005 with substitute body replacing the Makefet Fund with respect to early retirement arrangements for Company employees

On April 17, 2005 a special collective agreement was signed between the Company, the Workers Organization and the Histadrut, concerning an arrangement with am alternative entity to the Makefet Fund for everything relating to early retirement arrangements for Company employees.

In addition, on June 28, 2005, an agreement was entered into between Harel Insurance Company Ltd. ("Harel") and the Company. The contract regulates payment of pensions for early retirement and provisions for old-age and survivor pensions deriving from legislative amendments under the Israeli Economy (Recovery Program) Law for employees who retired from the Company from the end of 2003 / beginning of 2004 and/or who will retire from the Company in accordance with the special collective agreement for retirement of September 2000 as amended on March 18, 2004 and on April 17, 2005. Following execution of the agreement with Harel, the special collective agreement between the Company, employee representatives and the General Trade Union as aforesaid was amended on the same date (June 28, 2005).

As a result of the contract with Harel, the Company reduced its provision for early retirement, after performing adjustments that also stem from an updated estimate of the total retirement liabilities of NIS 90 million.

In this regard, see also Note 16D(1) to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

For a description of all of the Company's collective bargaining agreements, see Section 2.9.5 above.

2.18 Legal Proceedings

For information regarding legal proceedings, see Note 19 to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

2.19 Business Strategies and Goals

2.19.1 Forward-looking information

It is only natural that a review of Company strategy involves expectations regarding future developments with respect to customer behavior and needs, adoption rate of new services, technological advances, regulatory policy, marketing strategy employed by competitors, and the effectiveness of the Company's marketing strategy.

The Company's strategy and the business objectives derived from it are based on internal research, secondary information sources and primarily on reports issued by research groups, publications regarding activities by similar communications providers in Israel and around the world, and the work of consultants that have assisted the Company.

However, there is no certainty that the strategy and main activities described below will actually be realized or realized in the manner described below. The circumstances that may lead to non-implementation of the strategy or even its failure relate to frequent technological changes, regulatory constraints, design of a sustainable business model for new services the Company plans on providing and implementation of a preferable marketing strategy by competitors. Furthermore, a change in the ownership of the Company may also lead to changes in its strategy and business objectives.

2.19.2 Summary of strategy and Company's future plans

Vision and objectives

The Company has set a goal of reinforcing its position as the leading telecommunications company in Israel, while providing end-to-end solutions to business customers and creating a user experience for private customers, and providing quality service and business excellence.

In order to achieve this goal, the Company faces a number of challenges:

A. Maintaining its leading position in an ever-more competitive environment (leadership in service and strengthening values – product innovation, reliability, closeness to customer);

B. Reducing the decline in revenues from core services;

C. Generating new sources of revenue;

D. Adapting the organization to the competitive environment and operational excellence.

To implement the strategy and achieve said goals and objectives, the Company uses and will continue to use the following:

Business customers

A. Offering variety in its basket of products and services;

B. Providing a comprehensive solution based on the needs of the customer, while using a policy that dictates a commitment to quality and availability of service;

C. Encouraging customer migration from basic services for managed solutions to organizational and inter-organizational connectivity;

D. Offering a variety of value-added services.

Private customers

A. Continuing to penetrate broadband and improving infrastructures to increase bandwidth;

B. Providing differential pricing tracks;

C. Strengthening the positioning of the Company's telephony services, while focusing on advanced applications and penetration of advanced terminal equipment.

Network:

In order to achieve its strategic goals, the Company will strive to improve its network and adapt it to its business objectives, including:

A. The Company is examining the issue of deploying a new-generation switching network (NGN), which will allow it to launch new services with a shorter time to market, simplify the structure of the network, reduce maintenance and operation costs, and leverage real estate potential.

B. The Company is examining a policy that will allow a significant increase in bandwidth to customers by bringing the fiber closer to the customer home and integrating new technologies.

Changing organizational structure

For the Company's plans regarding changes to its organizational structure, see Sections 2.6.6(i) and 2.9.1 above.

2.19.3 Development trends in Company activities

A. The Company is working to increase bandwidth and data transmission rates for the services it provides to its customers. The Company takes marketing initiatives which are designed to switch its customers to its high speed internet service. Furthermore, the Company offers its business customers fast transmission and data communications services over a variety of protocols.

B. The Company is working towards integrating itself in IP (Internet Protocol) applications. It has therefore set up an IP network to serve as a platform for the services it currently provides and the additional services it plans to offer in the future.

C. The Company is studying the technological feasibility and the business model for distributing digital content (either owned by it or through license by third parties) over the Company's network and infrastructures.

D. The Company launched fixed-line and wireless home network services that enable multiple computers to connect simultaneously to the internet from a number of computers.

E. The Company launched a brand of telephones that operate on new technologies and which are equipped with advanced software. The Company is integrating the advanced phones as part of its marketing initiatives and the special offers it makes from time to time.

F. The Company is examining how to be part of provision of FMC (Fixed Mobile Convergence) services.

G. The Company has launched a variety of billing tracks for telephony services along with its basic tariff structure to increase the use of its services.

2.19.4 Main projects being planned or currently being implemented

The main projects currently being implemented by the Company include improving IPVPN services and those derived from it within the business sector, as well as upgrading the speed of ADSL-based high speed internet service to private customers. Additional projects include IP Centrex service as a platform for the provision of private virtual exchanges on the Company's private network. Furthermore, the Company is studying the significance of entering the FMC arena, by marketing dual phones that work both on the Company's network within the home or office and on cellular networks outside the home. From a technological perspective, the Company is preparing to conduct a field trial for customer migration in a number of services areas to a uniform IP-based network.

2.20 Events or Issues not within the Ordinary Course of Business

2.20.1 As set out in Section 1.3.2 above, in 2005, the State of Israel completed the process of sale of the core of its control of the Company, pursuant to the decision of the Ministerial Committee on Privatization, dated July 19, 2004, to the effect that the State's holdings of the Company would be sold by way of private sale of 30% of the share capital of the Company and the grant of options to purchase a further 10.66% of the share capital of the Company.

2.20.2 Upon completion of the privatization process and the Company's changing from a company controlled by the State of Israel to a company controlled by an entity that is not the State of Israel, the various restrictions imposed on the management and activity of the company, the restrictions regarding the terms of employment and other restrictions have been removed.

2.20.3 The "Industrial Espionage" Incident

2.20.4 In May, 2005, the media published that the Israel Police Force was conducting an enquiry regarding "industrial espionage" via computer systems in which, according to such publications, the subsidiaries of the Company – Pelephone, Bezeq International and DBS – were also involved. As a result, senior employees of those subsidiaries were called in for inquiry and/or to give evidence. In response to that: (1) Pelephone notified that neither it nor its employees had any connection to the obtaining of information by unlawful means, that it and its employees were surprised by the publications and that they would cooperate with the Police in order to clarify the facts in the incident. (2) Bezeq International gave notice that it would provide the Police with all assistance required, and that it would not have assisted or touched material obtained in unlawful ways. And (3) DBS gave notice that if offenses were committed against the law, they were committed in express contravention of its instructions and that it had not sufficed with entry into an oral contract with the investigation company, but rather, had had the investigation company sign an unequivocal undertaking to act only in accordance with the law, and the investigation company had undertaken that it and all those taking part in the agreement with it would act in accordance with the law. For this, see also Sections 19A(41) below.

It should be noted that a number of senior employees of the Company were summoned immediately after publication of the incident to give evidence to the Police regarding confidential documents of the Company which were found in the possession of competitors, and to evaluate the level of damage expected to be incurred by the Company as a result of such. The Company examined the matter and took immediate steps in order to reduce the danger of information being taken out of the Company as best it could.

On the implications of this incident on the privatization of the Company, see Section 1.3.2 above.

With respect to legal proceedings as a result of this incident – see Note 19A(40) to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

2.21 Risk Factors

A. Mounting competition

Competition in fixed-line domestic communications in specific sectors (such as data transmission and data communications) is already underway, and in the area of telephony – has also begun. Furthermore, the Company views the cellular telephony market as a market which, to a large extent, is an alternative to the fixed-line domestic telephony market.

The organizations currently competing against the Company or which may compete against it in the future are generally subject to government regulation that is not as strict as that with which the Company must contend. They benefit from far more business flexibility, including the ability to partner with subsidiaries and affiliates and market joint service packages with them.

According to the policy paper issued by the Ministry of Communications, the provision of telephony services over the Company's and HOT's broadband infrastructure (VOB services) will be allowed.

B. Government regulation

The Company is subject to government supervision and regulation that, among other things, relate to licensing for activity, determining permitted areas of activity, operation, competition, payment of royalties, obligation to provide universal service, determining tariffs, ability to hold its shares, relationships between the Company and its subsidiaries and prohibition to terminate or restrict its services (which may force the Company to provide services even when not economically feasible or when it goes against its interests). Said supervision and regulation at times lead to State intervention, which the Company believes adversely affects is business operations.

C. Regulation of tariffs and the phenomenon of cross-subsidy

The Company's tariffs for services are subject to State regulation. These tariffs are stipulated in regulations, and regulations also stipulate a formula for linking them to the changes in the Consumer Price Index, less an amount for depreciation. The practical implication of this mechanism is erosion (in real terms) of the Company's tariffs. Some of the Company's tariffs are subject to the Supervision of Prices for Commodities and Services Law. Furthermore, the bureaucracy involved in setting "tariff baskets" for the sale of service packages by the

Company delays the time to market of the tariff baskets, affecting the Company's ability to compete.

In recent years the tariff committees and regulatory agencies have worked to reduce the phenomenon of cross-subsidies in the Company's tariffs, but cross-subsidies still exist between the tariffs of various services offered by the Company, some of which are provided at a lower tariff than the cost of providing the service, and others are provided at a higher tariff. The Company cannot cancel or reduce cross-subsidy without the approval of the regulatory agencies.

D. Difficulties in labor relations and human resources

As a part of the preparations to cope with the increasing competition in the field, the Company must continue to formulate additional plans for organizational changes and make a further reduction in the number of personnel. The implementation of these plans has involved and is expected to involve, coordination with the employees and substantial costs, including the cost of compensation for early retirement, over and above the costs which are stipulated in existing agreements. The implementation processes of these plans have in the past caused and may cause in the future unrest in labor relations and hurt the Company's regular business.

Labor relations within the Company have been erratic over the years. The Workers Organization is actively involved in the Company's activities, and many managerial matters are subject to negotiation between the Company's representation and the management.

E. Restrictions on providing new services and on partnerships

The timetables stipulated in the Company's general license for approval of the services, the nature of the changes required by the Ministry of Communications for the service portfolio submitted and delay in the approval of the services by the Ministry do not allow the Company to increase the variety of its services at the pace it believes is required to respond to market-driven demand, and at the time required by the Company's customers.

F. Limitations regarding the relations between the Company and the companies in the Bezeq Group

The Company's general license obligates it to ensure that its relationship with its principal subsidiaries in the Bezeq Group does not cause them to be preferred over their competitors. Separation is required between the respective managements of the Company and said companies, and separation is also required in the financial and marketing systems, as well as assets and employees, and this gives rise to high management overheads. The Company is, at this stage, unable to offer joint service packages together with said companies. Due to the coming into being of communications groups in this field, which are not restricted in respect of such joint ventures, the level at which this risk factor affected the Company's operations has risen with the development of competition.

G. Legal proceedings

The Company is a party to legal proceedings, including class-action claims, which may cause it to have to pay significant sums, most of which cannot be estimated. Therefore provisions have not been made in the Company's financial statements and in those of companies in the Group.

Class-action claims can reach large amounts, as virtually all residents of the country are consumers of the Company's services, and a claim that relates to minor injury to a single consumer may become a significant case for the Company if it is recognized as a class action that applies to all consumers or a significant portion of consumers. Additionally, as the Company provides communications infrastructures as well as billing and collection services to other Licensees, parties initiating legal action against said Licensees in other class action cases may even try to involve Company as a party to these proceedings. (For legislative proceedings on the matter of class actions see Section 2.16.10 above).

For a description of the legal proceedings, see Section 2.18 above, which refers to Note 19 to the Company's financial statements for the year ended December 31, 2005, included in this periodic report.

H. Exposure to exchange rates and inflation

The Company assesses exposure to changes in exchange rates and inflation by the surplus or deficit of assets against liabilities based on the type of linkage. Therefore the Company is exposed to changes in exchange rates against the shekel. However, due to the currency hedging policy implemented by the Company, exposure has until now been low. The Company has taken and continues to take protective actions against most exposure from exchange rate fluctuations. That said, the Company has not fully neutralized its exposure to exchange rate fluctuations, by converting its liabilities denominated in foreign currency and/or linked to the consumer price index, to shekel-denominated liabilities.

I. <u>Electromagnetic radiation and licensing of broadcast installations</u>

The issue of electromagnetic radiation emitted from broadcasting installations is regulated both in the Pharmacists Regulations, in the Non-Ionized Radiation Law, 5766-2006 and in NOP 36. Furthermore, a number of bills have been proposed on this issue. (See Sections 2.15 and 2.16.)

The Company is working to obtain permits to build and operate its various broadcasting installation, however, the difficulties it faces in this activity, including difficulties related to the change in policy maintained by the various relevant organizations, may negatively impact on the infrastructure of said installations and on the regularity of provision of services using them.

The Company's third-party liability policy does not currently cover electromagnetic radiation.

J. <u>Frequent technological changes</u>

The field of communications is characterized by frequent technological changes and shortening of the economic lifespan of new technology. These trends mean that the entry barriers are lowered for new competitors, that depreciation rates increase and in certain cases, technology might become obsolete as might the networks owned by the Company, the cost of investment in which is still recorded on its balance sheets.

<u>Risk Factor Summary Table</u>

	Effect of Risk Factor on Company Activity		
	Large	**Medium**	**Small**
Macro Risks			
Exposure to exchange rate fluctuations and inflation			X
Sector Risks			
Increasing competition	X		
Government supervision and regulation	X		
Regulation of tariffs		X	
Electromagnetic radiation / licensing of broadcast installations		X	
Frequent technological changes		X	
Special Risks Faced by the Company			
Exposure in legal proceedings		X	
Difficulties in labor relations	X		
Restrictions on relations between the Company and companies in the Bezeq Group	X		
Restrictions on offering new services and entry into joint ventures		X	

3. Mobile Radio Telephone – Pelephone Communications Ltd. “Pelephone”)

3.1 General Information on Field of Activity

3.1.1 Pelephone’s field of activity

Four companies operate in Israel’s cellular communications market. Activity in the mobile radiotelephone sector (“MRT”) commenced with the founding of Pelephone in 1985. Pelephone engages in the provision of mobile cellular radiotelephone services (cellular communications), the marketing of terminal equipment, and the operation and maintenance of equipment and systems in the cellular communications field. Pelephone’s revenues include, *inter alia*, the charging for MRT communications customers (payments for call minutes, regular subscriptions, added value services and migration services, payment for the sale of terminal equipment and in respect of terminal equipment services) and revenues from other communications providers for interconnect (see sub-paragraph 3.18.2).

As of August 2004, Pelephone is wholly owned by “Bezeq” (hereinafter the “**Company**”)

3.1.2 Legislative and secondary legislation restrictions applicable to Pelephone

3.1.2.1 General license

Pelephone operates in accordance with an operating license from the Ministry of Communications - General License for the Provision of Mobile Radio Telephone Radio Services, which is valid until 2022 (hereafter: “**the license**”).

3.1.2.2 Tariff control

Some of the tariffs that Pelephone is permitted to collect from its subscribers are regulated by secondary legislation and also in pursuant to its license. In December 2004, the Telecommunications Regulations (Telecommunications and Broadcasts) (Payments for Interconnect), 5760-2000, were amended in such a way as to reduce tariffs for interconnect to the MRT network regarding call completion, transmission of SMS messages and to modify the method of calculating the duration of chargeable time. (See sub-paragraph 3.18.2).

3.1.2.3 Royalties

Pursuant to its license and to the Bezeq Regulations (Royalties), 5761-2001, Pelephone pays the State of Israel royalties at a rate of 3.5% of its revenues from the provision of telecommunications services net of income and expenses specified in the Regulations, foremost among which are: revenues from interconnect, payments transferred to the owner of an MRT operator for migration services, revenues from the sale of terminal equipment and bad debts related to revenues on which royalties were paid. In the year 2001, the rate of royalties was 5%, in 2002 – 4.5%, in 2003 – 4%, and in 2004 the rate of royalties was reduced to 3.5%. The Minister of Communications announced his intention of acting to institute an amendment in the Bezeq (Royalties) Regulations 5761-2001, such that, commencing 1.1.2006, the rate of royalties payable by the cellular companies would be reduced by an 0.5% each year, until scaled down to a rate of 1%. As at the date of this periodic report, these Regulations have not yet been made.

3.1.2.4 Environmental quality

The laying of the cellular infrastructure is subject to prior approvals from the Ministry of the Environment. The Ministry also establishes a standard for periodical radiation tests (see Clause 3.17).

3.1.3 Changes in the volume of activity in the field and in the profitability thereof

The following data relate to the volume of MRT traffic and the number of subscribers (total outgoing and incoming minutes in the Pelephone network):

	2005	2004	2003
Revenues (NIS millions)	4,428	4,412	4,055
Operating profit (NIS millions)	472	559	210
Number of subscribers at end of period[8] (in thousands)	2,343	2,132	1,955
Average use minutes per subscriber (MOU) per month	341	330	325
Average monthly revenue per subscriber (NIS) (ARPU)	139	153	160

3.1.4 Market development in customer attributes

In recent years, the cellular market has been characterized by lower growth rates than in the past. Growth rate competition encourages the companies to approach also customers making relatively little use of cellular services. Commencing 2003, Pelephone has been applying a "dual branding" strategy by means of the Pelephone brand, which addresses the adult community and business customers, and the Esc brand which addresses the youth community and "Mobile Entertainment" and multimedia service consumers. In the estimation of Pelephone, following the launch of the Esc brand, it has improved its market share in the years 2003 – 2005 among the "youth" community, which today stands at more than 30%.

3.1.5 Technological changes being such as to affect the company's field of activity

3.1.5.1 In 2004 Pelephone launched 3rd generation services in Central Israel by means of CDMA 2000 EVDO technology and is in process of spreading an EVDO network in the urban areas (for details see sub-paragraph 3.9). 3rd generation services to enable the Company to offer its customers a range of added value services (for details see sub-paragraph 3.2.1).

3.1.5.2 Pelephone chose the Motorola system by means of which it would be able to provide its customer with PTT (Push to Talk) services. This system is also operated by the two leading companies in the United States, which have a network employing the technology used by Pelephone. Setting-up of the system has been completed, and the service was launched at the beginning of 2005 in a reduced manner, and as of July 2005, the service is able to be marketed in full, without limitation. This service enables subscribers to initiate calls at the press of a button (without needing to dial) to an individual or a group on the data network, using VoIP (Voice over IP) technology.

3.1.5.3 Pelephone has the right to receive allocation of frequencies in ranges of 2000MHZ that can serve Pelephone for UMTS technology. (See Note 8D(2) to the Company's financial statements for the year ended December 31, 2005, included in this periodic report). The UMTS technology, if applied, will enable Pelephone to provide services requiring the rapid transmission of information, may solve the problem of wireless disturbances (see sub-paragraph 3.22F) and will enable use of standard terminal equipment supporting GSM/UMTS which will permit the reduction of prices of terminal equipment and migration services.

3.1.6 Critical success factors and the changes commencing therein

In the estimation of Pelephone, the following constitute the principal factors of success in its field of activity:

3.1.6.1 Significant investments on a regular basis in the cellular infrastructure, both for the purpose of improving and securing maximum high quality media coverage throughout Israel, which is a basic condition for the provision of

[8] Subscriber data relate to active subscribers having received or made at least one call in the past six months.

Pelephone services, and to provide customers with the most advanced services using the most progressive technological infrastructure.

3.1.6.2 Customer support and customer service in such a way as to enable Pelephone to retain its customers in a competitive market.

3.1.6.3 Ongoing expansion in the field of added value products and services supplied to Pelephone's customers.

3.1.6.4 Continuing success of the Company's marketing strategy for consolidating "Pelephone" brands addressing the adult market and business customers and the "Esc" brand addressing the youth and multimedia service consumers market.

3.1.7 Principal entry and exit barriers

The principal entry barrier to the cellular market derives from the need for a MRT license and the allocation of the frequencies, as well as the regulatory supervision to which the market is subject (see Clause 3.18). An additional entry barrier derives from the need for weighty investments in infrastructure, which are affected by frequent technological changes.

The field's principal exit barriers from this field derive from long-term agreements with infrastructure suppliers and property owners with whom Pelephone enters into leasing contracts, and major investments that are recoverable by the company over a long period of time. In addition, Pelephone is committed to the provision of service to its customers in accordance with the conditions stipulated in its license.

3.1.8 Substitutes for Pelephone products

Domestic fixed-line telephone services provided by the domestic operator companies may constitute a substitute for some of the services provided by Pelephone.

VoIP technology-based telephony services are likely to be substitutes for cellular services in areas where local wireless networks provide coverage.

3.1.9 Structure of competition in the sector and changes therein

Until the end of 1994, Pelephone was Israel's sole cellular company (until the end of 1993 – by virtue of the company's license and on its behalf[9]). In May 1994, Cellcom Israel Ltd posted the successful bid in an invitation to tender for a second operator for MRT service (hereafter: "**the second operator"** or **"Cellcom").** In February 1998**,** a third operator was selected by invitation to tender – namely Partner Communications Ltd. (**hereafter: "the third operator" or "Partner").** As of February 2001, MIRS Communications Ltd., (hereafter: "**MIRS")** has been operating as an additional cellular operator. After the entry of the second operator, and later, the third operator, into the cellular market, fierce competition developed among the operators (primarily Pelephone and the second and third operators). This competition resulted in market saturation expressed in the diminution of the number of subscribers joining the company, an increase in the transfer of customers between the cellular companies and an erosion of the real prices collected by Pelephone from its customers for services rendered by it (see Clause 3.7).

3.2 Products and Services

3.2.1 Pelephone provides its subscribers with comprehensive services of voice transmission, data communications and advanced multimedia services through its network.

Basic services (VOICE) – Pelephone's service package includes basic voice services and also auxiliary services such as – call waiting, follow-me, voice mailbox, voice conference call and caller ID.

Advanced services and products (hereafter – "added value services") - the subscriber may purchase added value services such as information services using SMS, voice information services using special-purpose asterisks, information and entertainment services via the Internet portal and advanced content services such as JAVA games,

[9] The change was actually made in April 1994 and was applied with retroactive effect to the beginning of 1994.

network games and video games. Among others, the subscriber may choose by means of the Pelephone Internet portal animation items or different ring-tones. Also, the subscriber may obtain services connected to his electronic diary (Outlook services) enabling the subscriber to obtain SMS messages regarding the arrival of e-mail messages, and to read and reply to them, all through his handset. Moreover, using his handset, the subscriber can look at and update his electronic diary, and view his address list. The subscriber can also receive SMS notice of scheduled events found in his electronic diary.

The added value services offered by Pelephone are location-based services. *Inter alia,* these services enable, while driving, early warning of an approaching police speed trap, guidance as to the fastest route from point to point, and information regarding the nearest points at which certain services needed by the subscriber may be obtained. The service also enables the employer to obtain information as to the location of his employees carrying a cell-phone.

Pelephone started supplying added value services as from the end of 2002. In 2004 and 2005, revenues from value added services constituted some 7% - 8% correspondingly, of its revenues from Pelephone services and terminal equipment services. Pelephone anticipates an ongoing increase in added value service revenues in future years.

3rd generation services – with the upgrade of the network to a network using EVDO technology, Pelephone now offers its customers 3rd generation services including watching television channels such as: the news, music, sports and various entertainment channels. At present, more than 70,000 subscribers use 3rd generation services.

3.2.2 Pelephone provides roaming services (communications via MRT from various locations worldwide). In order to facilitate similar services also in Europe and in other countries where the network is not based on CDMA technology, Pelephone leases to its customers handsets adapted to the technology existing in those countries, in accordance with agreements between Pelephone and cellular operators in those countries. During 2005, Pelephone began supply of dual handsets which support CDMA and GSM technology. The handsets will provide an additional solution to roaming services in other countries where the network is not CDMA.

3.2.3 Pelephone offers its customers ongoing repair service, against a monthly payment, providing warranty for the cellular telephone.

3.2.4 Pelephone offers its customers various types of mobile telephone and auxiliary accessories (hereafter – terminal equipment). With the launch of the 3rd general EVDO technology services, Pelephone commenced providing its customers, in 2004, with terminal equipment supporting of those services.

3.3 Segmentation of Revenues and Profitability from Products and Services

The following are data on the breakdown of Pelephone revenues (in NIS millions):

	2005		2004		2003	
	NIS millions	% of revenues	NIS millions	% of revenues	NIS millions	% of revenues
Revenues from Pelephone services and terminal equipment services	3,704	84%	3,773	86%	3,506	86%
Revenues from the sale of terminal equipment	724	16%	639	14%	549	14%
Total	4,428	100%	4,412	100%	4,055	100%
Percentage of gross profit		23%		26%		20%

3.4 New Products

In 2004, Pelephone launched the EVDO 3rd generation technology (see sub-paragraph 3.9.1.6).

At the beginning of 2005, Pelephone launched its PTT (Push to Talk) services (see sub-paragraph 3.1.5.2).

3.5 Customers

Pelephone has two brands: the "Pelephone" brand which addresses private and business customers and the "Esc" brand which addresses youth, consumers of "mobile entertainment" and multimedia services (see Clause 3.1.4).

As at the end of 2005, approximately 70% of Pelephone's subscribers are private customers and 30% of Pelephone's subscribers are business customers.

3.6 Marketing, Distribution and Service

Pelephone's distribution system is based on approximately 3,500 independent sales, service and marketing personnel, approximately 100 points of sale (some of which are operated by Pelephone employees and others of which are operated by independent resellers) and 38 service and sale points around the country, which deal in service and sale to customers, handling of faults, repair of handsets and sale of services and handsets, and in addition, there are also service representatives for the business sector.

Pelephone's subscriber service system includes 10 call centers which provide information, service on various matters, technical support, data regarding customer billing and general information.

Up until the end of 2003, there was a separation between the service system and the sales system. During 2004, Pelephone began taking steps to modify the sales and service points system in order to increase the number of points at which both selling and service could take place.

At the end of 2005, these two divisions were unified into a single customer and private sector service division. Purpose-based service and sales operations are integrated at all points of contact with customers.

3.7 Competition

3.7.1 Pelephone faces fierce competition from the other cellular operators: Partner, Cellcom and MIRS. This competition has resulted in a large increase in market volume and the addition of new subscribers, and the erosion of real prices throughout the market. As a result of the penetration of MRT operators into sectors making relatively low use of cellular services, there commenced, as from mid-1996, a decrease in average minutes of use per subscriber and hence in the average revenue per subscriber.

As at December 31, 2005, Pelephone has approximately 2.3 million subscribers. To the best of Pelephone's knowledge, as at December 31, 2005, Cellcom has approximately 2.5 million subscribers, Partner has approximately 2.4 million and MIRS has approximately 370,000 subscribers[10].

3.7.2 On June 3, 2004 the Communications (Telecommunications and Broadcasts) (Processes and Conditions for Obtaining a General Special License) Regulations 5764-2004 were published. Under the aforementioned Regulations, an application may be filed for a special general license, i.e. for a license for the provision of domestic fixed line telecommunications services, which does not involve an obligation to provide service to the entire public everywhere in Israel. Pelephone, as a subsidiary of the Company, is obliged, unlike the other cellular companies, to apply the Minister of Communications and persuade him that the award of a license to a subsidiary of Pelephone is such as to promote the competition in the telecommunications field or is in the public interest.

The Company's license imposes restrictions on it in all matters pertaining to cooperation with its subsidiaries. In the opinion of the Company and Pelephone, to the extent that these restrictions remain in force, without, at the same time, similar restrictions being imposed on the competing MRT operators, they will, as stated, adversely affect Pelephone's ability to compete with the competing carriers.

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[10] Data on the subscribers of Pelephone, Partner, and MIRS relate to active subscribers having received or made at least one call in the past six months, Cellcom data relate to active subscribers in the past three months.

The Ministry of Communications some time ago gave notice, as part of a process of final formulation of its policy regarding the field of licensing of supply of telephony services by way of a broad band access service (VOB), of its intention not to permit the companies in the Bezeq Group (including Pelephone) to take part in this field so long as the Company's portion of the fixed-line domestic telephony field in the segment of certain customers does not fall below a given threshold, or earlier taking into account the situation of competition in the field, after an examination to take place at examination stations on the timeline and on prescribed dates. Pelephone objects to this policy and is of the opinion that it should be treated as an independent body, due also to the existence of the restrictions imposed upon it regarding joint marketing with the Company. Pelephone is waiting to present its arguments in a hearing before the Ministry of Communications. Pelephone has submitted an application to the Ministry of Communications for the effecting of a marketing trial of VOIP technology, and in response, the Ministry noted that it could grant Pelephone a license for such trial subject to conditions, that main ones of which would be a provision in the license that if at the end of the hearing the policy document is amended, such that Pelephone is prohibited from providing VOB services, the trial license shall expire. A draft of the license has been approved by the Ministry of Communications and upon provision of a guarantee by Pelephone in favor of the State, it will be given an experimental license. (In this regard, see also Section 2.6.1 above)

3.7.3 On March 22, 2005, the joint Finance and Economics Committee of the Knesset approved an amendment to the Communications (Telecommunications and Broadcasts) Law, 5742-1982 to the effect that the Minister of Communications is to prepare a numbering plan regarding number portability with respect to a general licensee for provision of MRT services and a licensee for domestic fixed-line communications services, and to instruct them regarding the implementation and activation of it by September 1, 2006 (this date may be extended to December 31, 2006). The licensee is to be required to provide number portability for any subscriber that may request such, and is to do all of the acts required for such purpose without any payment from the subscriber or from any licensee. Implementation of the number portability plan will impose costs on Pelephone, the complexity, scope and implications of which cannot yet be assessed. In addition to the anticipated costs as aforesaid, implementation of the number portability plan is expected to affect competition in the field. As at the date of writing this Report, Pelephone, and to the best of Pelephone's knowledge, the other cellular companies and the Company as well, are not in compliance with the timetables, and notice in this regard has been given to the Ministry of Communications from all of the companies. The Ministry of Communications has not given notice of any change in the timetables. (In this regard, see also Section 2.6.5 above).

3.7.4 As part of its preparations for meeting the competition, Pelephone took a number of steps designed to preserve its market share and profitability. Pelephone's principal marketing strategy was to create differentiation for its services, based on accentuating the quality of its services and its product diversity. Commencing January 2003, Pelephone has been applying a dual branding strategy: the "Pelephone" brand addresses the adult community and business customers, while the "Esc" brand addresses the youth community and advanced multimedia service consumers.

Pelephone chose this strategy on the understanding that the market consists of a number of target publics, each having different needs. In the opinion of Pelephone, activity under two brands enables it to provide a better response to each target public, while making it better able to compete in each arena against the competing brands.

3.7.5 In order to enable migration services in Europe or other countries where the network is not based on CDMA technology, Pelephone rents to its customers handsets conforming to the existing technology in those countries, unlike competing MRT operators which operate GSM technology networks, and whose subscribers, holding terminal equipment based on that technology, can make use of their terminal equipment also in other countries whose networks employ that technology and do not need to hire special terminal equipment.

3.7.6 Positive and negative factors affecting Pelephone's competitive position

Positive factors

A. The advanced 3rd generation cellular network supporting the download of data at a rate of up to 2.4 Mbps, and providing good network quality.

B. An advanced product range including DATA solutions for businesses, and a broad spectrum of multimedia and entertainment services.

C. Two strong brands, each in its relevant arena: Esc in the youth arena and Pelephone in the adult and business sector arena.

D. Service system and range of customer service interfaces enabling the provision of high-level service to customers.

E. An extensive distribution system specializing in the provision of solutions appropriate to each type of customer.

F. Strong capital structure and positive cash flow.

Negative factors

A. Pelephone is subject to restrictions on entering into additional fields of activity and on expanding its customer service baskets, which do not apply to the competitors.

B. There exists a restriction on joint activity with the Company in the marketing of joint service packages.

C. CDMA technology does not enable as full enjoyment of roaming services as competitors provide.

3.8 Seasonal Fluctuations

Pelephone's revenues and profitability are affected, albeit not to any material extent, by seasonality and holidays. The second and third quarters are characterized by higher revenues than the first and fourth quarters. This is due primarily to different usage patterns prevailing in the summer months compared to the winter months and the holiday season. Seasonal fluctuations only affect cellular services revenues, but, as stated, the effect is not material.

3.9 Fixed Assets and Facilities

Pelephone's fixed assets include infrastructure equipment in sites, electronic equipment, computers and software systems, motor vehicles, terminal equipment, office furniture and equipment and leasehold improvements.

3.9.1 Infrastructure

3.9.1.1 Pelephone's infrastructure investments

Investments in the years 2003 – 2005 served primarily to replace and upgrade the network to 20001XRTT CDMA and EVDO technology.

3.9.1.2 Pelephone operates two communications networks using three technologies:

A. Digital technology using CDMA2000 1XRTT. This is a state-of-the-art technology and its advantages are the ability to provide advanced services, greater capacity for talk calls and data for a given quantity of frequencies and fast data communications (up to 144KB). Today more than 99% of the traffic on the Pelephone network passes through a network employing this technology.

B. Digital technology using the EVDO method – see sub-paragraph 3.9.1.6 hereinafter.

C. Analog technology using the NAMPS (Narrow Band Advanced Mobile Phone System). This is outdated technology which has not undergone network development processes and today less than 1% of Pelephone customers use cellular instruments making use of this technology.

The three technologies operate on the same frequency range allocated to Pelephone. At the beginning of 2002, the board of directors of Pelephone decided to upgrade the densely populated urban area to CDMA2000 1XRTT technology, using equipment manufactured by Nortel. 1XRTT technology enables more efficient utilization of the frequencies at Pelephone's disposal, and also information transmission at the greater rapidity required for wireless Internet and for additional portal applications. In mid-2003, the decision was reached to continue to upgrade the Pelephone network in the other parts of Israel, using equipment manufactured by Motorola. By the end of 2003, the upgrade of the Pelephone network to 1XRTT technology was completed throughout Israel.

3.9.1.3 As at the date of publication of the report, Pelephone's MRT infrastructure (CDMA) is based primarily on 8 digital switches manufactured by Nortel, connected to approximately 1,410 radio sites (cells), in a countrywide spread. Each radio site incorporates an antenna for reception and transmission and a computerized control system, and covers a certain geographic area. The cells are connected to base station controls (BSC) that are hooked up to the switches. The switches are connected to one another and to all the other telecommunications operators (Bezeq, Partner, Cellcom, MIRS and international operators).

3.9.1.4 The depreciation rate of the site equipment is up to 10 years, depreciation for switching equipment is 5 – 7 years, and for data communications equipment and computers between 3 and 5 years. The depreciation period of the equipment is determined on the basis of engineering opinions based, *inter alia*, on generally accepted practice in various other countries.

3.9.1.5 Pelephone's infrastructure equipment is manufactured by Nortel and Motorola. Each of Pelephone's digital switching networks is manufactured by Nortel, and the Nortel telecommunications networks covers most of the coastal plain and Jerusalem (from Ashdod to Haifa). The Pelephone network in the rest of Israel uses the Motorola-manufactured telecommunications network.

3.9.1.6 At the end of 2003, the Pelephone Board of Directors resolved to upgrade the CDMA2000 1XRTT network to EVDO technology by means of the addition of a special–purpose carrier for data communications in the urban areas of Israel. This technology enables communication between the network and the terminal equipment at rates of up to 2,400 KSS and between the terminal equipment and the network at rate of up to 144 KSS. In the invitation to tender for the upgrade of the network, the winning bid was posted by Nortel. Total cost of the project is approximately $44 million. Deployment of the network under the contract commenced in June 2004 and is to be concluded in the first quarter of 2006. Concurrent with the set up of the network, a portal was established for video services, enabling customers to watch live broadcast channels, to download music clips, entertainment and news files, etc. This portal is the key service using EVDO technology.

3.9.1.7 In 2005, Pelephone acquired equipment from Nortel, in a long-term transaction for 2005-2007, for the expansion of its network, including 150 sites and equipment to upgrade the capacity of the network. The transaction is for approximately 20 million dollars, of which the 2005 portion is approximately 11 million dollars. In addition, another transaction – for 4 million dollars – was also entered into with the purpose expanding capacity and making it comply with the 2006 plan.

3.10 Intangible Assets

3.10.1 MRT license

Pelephone operates pursuant to a license issued to it (a general license for the provision of mobile radio telephone (MRT) services), which is valid until 2022 (see sub-paragraph 3.18.1.1). The license constitutes the basis for Pelephone's activity.

3.10.2 Frequency usage right

Pelephone uses frequencies in the 800 MHZ range, granted to it by virtue of its license. These frequencies are used by the company for CDMA2000 1XRTT technology and

EVDO technology. In addition, Pelephone was granted the right of future allocation and use of frequencies (in the 2000 MHZ ranges) using UMTS technology. In this regard, see Note 8D(2) and Note 10 to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

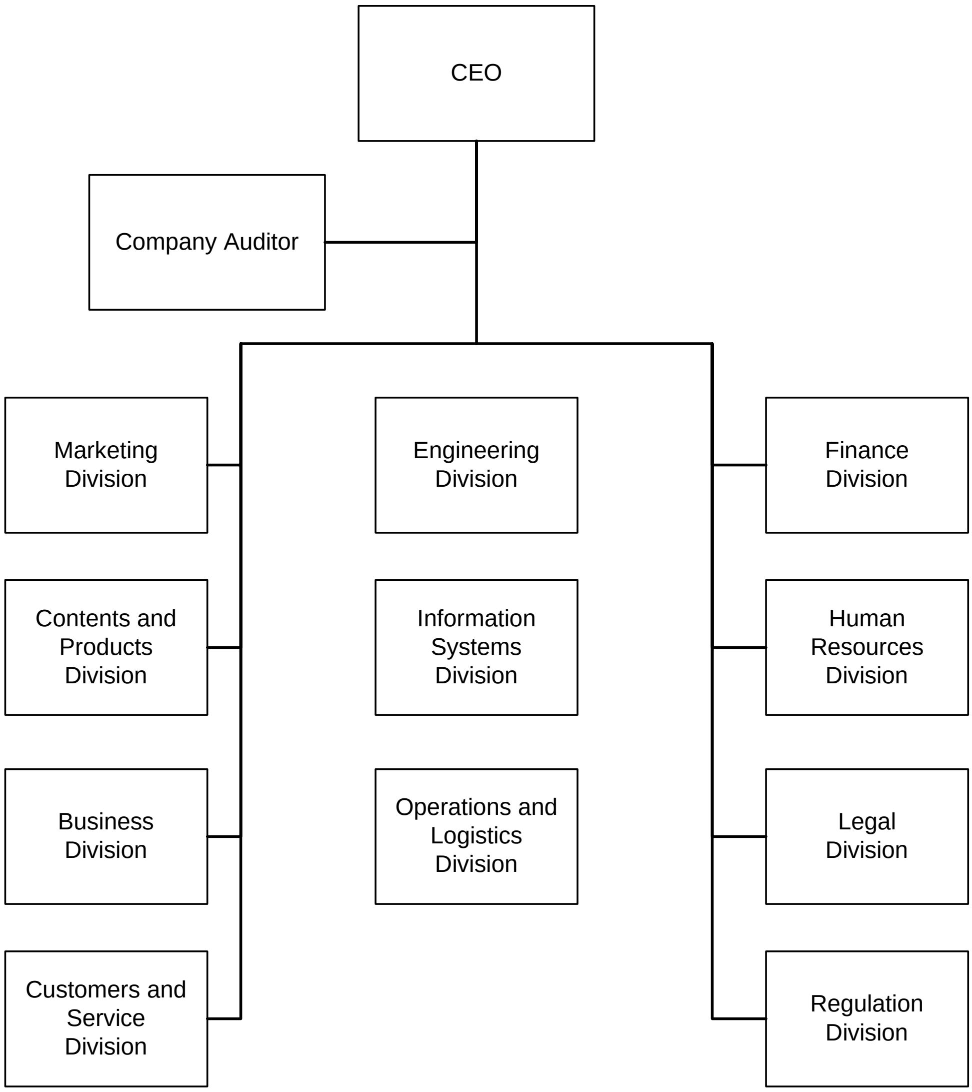
3.10.3 Trademarks

Pelephone has a number of registered trademarks. The principal ones are: the “’Pelephone” brand directed at the adult public and business customers and the “Esc” brand directed at youth.

3.11 Human Capital

3.11.1 Organizational Structure

The following is a diagram of Pelephone’s organizational structure:



In the final quarter of 2005, a number of organizational changes took place at Pelephone:

The CEO of Pelephone ceased to hold office and was appointed CEO of the Company;

The Deputy CEO of Pelephone was appointed CEO of Pelephone;

The Senior VP Operations and Customer Services at Pelephone ceased to hold office and was appointed Deputy CEO of the Company;

The Chairman of the Board of Directors of Pelephone ceased to hold office;

The VP Terminal Equipment ceased to hold office and the Terminal Equipment Services Division was united with and taken over by the Logistics and Operations Division;

The organizational structure of Pelephone changed as a result of these changes, as set out above.

3.11.2 Table of organization

The following details the number of employees[11] in Pelephone in accordance with its organizational structure.

Division	Number of employees	
	31.12.05	**31.12.04***
Headquarters and management	218	219
Marketing and Product Content Division	84	92
Customer Service and Private Sector Division	2,472	2,554
Business Division	390	375
Operations and Logistics Division	405	438
Engineering and Information Systems Division	571	556
Total	4,140	4,234

* Presented again (due to changes in organizational structure of company).

3.11.3 Changes in the number of employees during 2005

At the end of 2005, Pelephone's manpower stands at approximately 4,140, compared with approximately 4,230 at the end of 2004.

3.11.4 Instruction and training

Pelephone invests resources in professional training in accordance with the type of employee and the field in which he is active. Most training courses take place in the service field, primarily in the service division. Pelephone's total expenses in 2005 and 2004 in respect of instruction and training amount to NIS 12 million and NIS 13 million, respectively.

3.11.5 Employee reward schemes

It is the practice of Pelephone to award its employees, managers and office-holders grants and incentives on a monthly, quarterly and annual basis commensurate with their achievement of the targets set for them and in accordance with the type of work done by the employee.

3.11.6 Employment contracts

All of Pelephone's employees are engaged on the basis of standard personal contracts in accordance with the professions and functions in which they engage.

For changes to the board of directors following the change in control of the Company, see Section 1.3 above. Following the appointment of the CEO of Pelephone to the position of CEO of the Company, changes also took place to management of Pelephone.

3.12 Products and Suppliers

The Pelephone products' inventory includes a range of cellular telephone units and a range of auxiliary accessories (such as: battery, hands-free kit, earphone, data cable, charger and so forth). Pelephone also maintains inventory of spare parts for the purpose of supplying repair services to its customers and an inventory of used handsets.

[11] The number of employees represents the number of jobs as calculated by Pelephone (total work hours divided by monthly work-hour standard).

Total acquisitions of terminal equipment in 2005 amounted to NIS 958 million. Pelephone acquires the terminal equipment and auxiliary accessories from various importer-suppliers in Israel.

Contractual engagements with the suppliers are entered into on the basis of framework agreements setting forth, *inter alia,* the technical support provided by the supplier for the terminal equipment it supplies, the availability of the spare parts and the turnaround time for repairs. These agreements include a commitment to make acquisitions, which are implemented regularly by means of purchase orders.

If a contract with a particular terminal equipment supplier is discontinued, Pelephone may increase the quantity purchased from other terminal equipment suppliers or procure terminal equipment from a new terminal equipment supplier. If the replacement of a supplier is required, as aforementioned, the replacement shall not be immediate, and shall be subject to a special preparatory period for purchasing spare parts and accessories, including the repair capacity for all types of faults required, in order to enable the provision of service to customers as agreed.

Replacement of a supplier shall involve additional extraordinary expenses as a result of such equipping. The splitting of terminal equipment purchases between suppliers does not create significance dependency on any one supplier or equipment model.

3.13 Working Capital

3.13.1 <u>Policy governing inventory maintenance, return of merchandise and warranty</u>

The amount of inventory maintained is derived from Pelephone’s service policy and from selling requirements. The requirements necessitate maintaining an inventory for a period of 3 – 5 inventory months, depending on the type of inventory. As at the end of 2005, the inventory level stands at an amount of approximately NIS 199 million.

Return of handset inventory may be implemented by cancellation of a transaction or by the replacement of a handset for another (of the same standard or a higher standard against incremental payment to cover the price difference.)

Pelephone provides service, warranty and maintenance for terminal equipment in accordance with the level of service and repairs to which the customer has subscribed.

3.13.2 <u>Policy governing credit to customers</u>

3.13.2.1 Credit in handset sale transactions – Pelephone enables most of its customers purchasing a mobile telephone to spread payments over 36 equal installments.

3.13.2.2 Credit by monthly charging in respect of MRT services – Pelephone customers are charged once a month in charging cycles taking place on different dates over the course of the month, in respect of the consumption of MRT services in the preceding months.

As at 2005, average customer credit amounts to NIS 1,234 million.

3.13.3 <u>Credit from suppliers</u>

Pelephone receives credit from its suppliers for periods ranging from 30 days to 90 days. As at 2005, average credit from suppliers and various creditors amounted to NIS 612 million.

3.14 Investment in Investee Companies and in a Partnership

As at September 30, 2005, Pelephone held 85% of the B-one partnership (hereinafter: the “Partnership”). At the end of the third quarter, it was resolved to wind up the Partnership. As of the fourth quarter, Pelephone has taken over management of the undertakings given by the partnership. See Appendix A (Section 8) to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

3.15 Financing

3.15.1 Pelephone's operations are financed out of shareholders' equity, long- and short-term bank loans, debentures and supplier credit.

The average interest rate in 2005 for undesignated loans was:

	Short-term loans	Long-term loans (including current maturities)
Banking sources:		
CPI-linked – NIS	–	4.89
Fixed shekel	4.48	7.18
Dollar	–	4.37
Non-banking sources:		
CPI-linked – NIS		4.65

3.15.2 <u>Restrictions</u>

3.15.2.1 <u>Undertakings towards banks</u>

As part of the arrangements made with banks in Israel and overseas in connection with the provision of credit to Pelephone, Pelephone provided the aforementioned banks with certain irrevocable undertakings, consisting primarily of the following:

A. Pelephone's total debts not to exceed three times its shareholders' equity.

B. As long as total debts exceed shareholders' equity by more than 2, Pelephone shall not pay out dividends and shall not pay management fees to shareholders. If Pelephone is in breach of this undertaking, it shall, within 120 days of demand, be required to repay the bank all loans outstanding to the credit of the bank at such time, or, alternatively, to amend the breach by increasing its shareholders' equity or repaying Pelephone's loan in such a way that the aforesaid ratio is preserved;

C. Total debts shall not exceed NIS 3.8 billion (linked to the CPI known as at January 2002). The sum of the debts shall be checked once every quarter in accordance with the financial statements that have been reviewed by accountants;

D. Not to mortgage Pelephone's assets under a fixed or floating charge, in any manner or way, or of any kind or degree, without obtaining the bank's prior written consent to such;

E. Not to provide Pelephone's shareholders or any third party whatsoever with any security or charge over the assets of Pelephone or any guarantee to secure credit received by the shareholders, without obtaining the bank's prior written consent to such;

F. Not to grant Pelephone's shareholders any loan or credit without obtaining the bank's prior written consent to such;

G. To provide the Bank various information, details and reports;

H. If Pelephone is in breach of its aforementioned undertakings, then the bank shall be entitled to call for immediate repayment the amounts of the loans extended to it.

3.15.2.2 <u>Undertakings to foreign bank</u>

Pelephone has given gave an undertaking to a foreign bank not to engage in any transaction or series of transactions under which assets are to be sold, mortgaged or otherwise transferred other than in the ordinary course of business, without obtaining the bank's consent, and not to perform any act of merger (except a merger with Bezeq) without obtaining such the bank's consent. Likewise, certain instances were stipulated in which the bank may call for immediate repayment of Pelephone's loans, the most significant being:

(a) If Pelephone fails to pay to the lending bank any payment having fallen due.

(b) If Pelephone is in breach of its undertakings to comply with the financial criteria as aforesaid.

(c) If Bezeq ceases to be a controlling shareholder in Pelephone and the lending bank is not convinced that such change does not materially effect Pelephone.

(d) If any material change takes place in Pelephone.

(e) If Pelephone pursues any unlawful activity.

(f) In the event that a competent authority intervenes in the affairs of Pelephone.

(g) If the management of Pelephone is removed from office or if Pelephone's power to manage its affairs is curtailed and such curtailment materially affects its business.

(h) If Pelephone's license is revoked.

(i) If any material change takes place (without the consent of the bank) in the nature of Pelephone's business or in case of nationalization or sale of all or most of Pelephone's assets by any Government or by virtue of any authority vesting in it.

(j) If Pelephone fails to pay any one of the group of banks to which it has furnished an undertaking regarding financial criteria, any payment on due date thereof or if it is determined that its debt to any of the aforesaid group is due for payment or if any of the group of lenders has a right to call in Pelephone's debts to it for payment prior to the agreed due date thereof (provided that the amount to which all of the aforesaid applies shall be not less than 10 million dollars).

(k) If Pelephone is insolvent or is found by a court to be insolvent.

(l) If proceedings are instituted against Pelephone such as receivership, liquidation, settlement or arrangement with creditors.

(m) If the monetary loan becomes unlawful as regards the lending bank.

In addition, if an agreement with Pelephone contains a tax grossing up Clause whereby, if any tax or levy shall apply to the lender, it shall be borne by Pelephone. To date, Pelephone has not been required to gross up tax payments, other than the grossing up of a tax withholding on the interest payable to lenders. In respect of loans from local banks, no tax obligation exists, and in respect of the loans obtained from the aforementioned foreign banks, Pelephone is exempt from payment of tax out of the interest in accordance with an exemption approval confirmation provided by the Income Tax Commission.

3.15.2.3 Immediate repayment of the loan

A lender may call a loan for immediate repayment in certain instances (usually after serving written warning notice on Pelephone), foremost among such instances being: (A) if any debt to the lender was not paid; (B) if Pelephone adopts a liquidation resolution or if application for liquidation or for the appointment of a liquidator is filed against it or if there is cause for its being liquidated, or for the appointment of a receiver or a trustee; (C) if application is filed for the imposition of an attachment or if an attachment is imposed on the assets of Pelephone or if any execution proceeding is taken against its assets or if it ceases to repay its debts; (D) if Pelephone adopts a resolution in favour of restructuring, merger or settlement or if the control therein is transferred without the lender's consent; (E) if Pelephone ceases to repay its debts or reaches a compromise with its creditors or any of them;

(F) if Pelephone is in breach of any undertaking that it has assumed toward the lender or if it should transpire that a material declaration by Pelephone toward the lender is untrue; or (G) if an event should has occurred as a result of which any entity shall have the right to call for immediate repayment of Pelephone's debts towards it (even if such concerns does not make use of its right).

3.15.3 **Issue of debentures**

On February 27, 2005, Pelephone issued NIS 500 million par value debentures, by way of private placement to institutional investors, in consideration for their par value. The debentures are linked to the CPI, bear annual interest at a rate of 4.4% and are to be paid out in 20 equal semi annual payments commencing as of September 2005.

On June 29, 2005, Pelephone issued NIS 333 million par value debentures, by way of private placement to institutional investors, in consideration for their par value. The debentures are linked to the CPI, bear annual interest at a rate of 4.55% and are to be paid out in 20 equal semi annual payments commencing as of January 2006.

At the time of issue of the debentures, trust deeds were executed by the Company, for the trusteeship of Union Bank of Israel Ltd., which is to act as trustee for the debenture-holders. Pursuant to this agreement, Pelephone undertakes to pay principal, interest and indexation differences in accordance with the terms of the debentures. The debentures are not secured by any charge, and the conditions of the negative pledge and the credibility of the financial data that Pelephone maintains in relation to the Israeli banking system will also apply to the debenture holders (see Clause 3.15.2 aforementioned). The agreement details the conditions for immediate repayment of the debentures, being essentially as follows: (A) If Pelephone does not repay any amount whatsoever being due from it pursuant to these debentures by 30 days from the due date; (B) if a liquidator is appointed for Pelephone; (C) if charges are realized; (D) if an attachment is imposed on material assets of Pelephone; (E) if Pelephone ceases to exist or (F) if Pelephone discontinues its payments or serves notice of its intention to discontinue them. The trustee is entitled to take steps for immediate repayment in order to protect the debenture holders. The agreement moreover determines forth principles for indemnifying the trustee, trusteeship of the receipts, investment of moneys and conditions for convening a general meeting and adopting resolutions.

The debenture issuance was awarded AA minus rating by the Maalot rating company.

As at December 31, 2005, Pelephone is meeting its commitments to the banks and to the debenture holders.

No loans have been taken out since December 31, 2005.

3.15.4 Credit limits

The credit limits assigned to Pelephone by Israeli and foreign banks amount ot NIS 3.14 billion as at the date of the periodic report. There is no signed agreement with the banks regarding this amount, but rather a verbal agreement. As at December 31, 2005, Pelephone had utilized NIS 1.35 billion of its credit limit at banks.

3.15.5 Guarantees and charges

See Note 19C to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

3.15.6 Variable interest

As at December 31, 2005, Pelephone has no variable interest loans. Pelephone was, however, granted a loan by a foreign bank, renewable every three months within a framework set at three years. The interest, varying every three months, is calculated by either of two possible alternatives, a shekel track and a dollar track, at the discretion of the bank.

3.15.7 Credit rating

The rating company Maalot assigned Pelephone an AA minus rating on issuance of the debentures (see sub-paragraph 3.15.3 above).

3.15.8 Pelephone's estimate of fundraising in the coming year and sources of financing

Pelephone is due to repay a large portion of its loans during 2006, by way of short-term investments and current cash flow. If necessary, Pelephone will raise new loans from banking corporations and/or by raising capital on the capital market.

3.16 Taxation

See Note 11 to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

3.17 Environmental quality

3.17.1 Provisions relating to the Environment – see sub-paragraphs 1.18.1.3 and 3.22.G below.

3.17.2 Anticipated costs and investments

Pelephone conducts periodical radiation tests in order to ascertain that it is in compliance with the permitted operating standards and the standards of the International Radiation Protection Agency. These tests are outsourced to companies authorized by the Ministry for the Environment. Pelephone invests on average NIS 4 million per annum in respect of this activity.

3.18 Restrictions on and Control of Pelephone's actions

3.18.1 Statutory restrictions

3.18.1.1 Communications Law and licensing obligation thereunder

The Communications (Telecommunications and Broadcasts) Law 5742-1982 stipulates, *inter alia*, that that performance of telecommunication activity and the provision of telecommunication services, including the MRT services, are subject to a license from the Minister of Communications (in this chapter – the Minister).

Pelephone holds a general license for the provision of MRT services. The Minister is empowered to modify the terms of the license, to add thereto or to detract therefrom, while taking into consideration, *inter alia*, government telecommunications policy, considerations of public interest, suitability of the license holder to provide the services, the contribution of the license to competition in the telecommunications field and to the level of service therein.

Moreover, the Minister empowered to annul, restrict or suspend a license in a number of situations (see Section 3.18.3.1 below).

The Law authorizes the Director-General of the Ministry of Communications to impose financial sanctions for various violations of the provisions of the law and of orders and directives issued by virtue thereof, and for violation of the license terms.

3.18.1.2 Wireless Telegraph Ordinance

The Wireless Telegraph Ordinance [New Version] 5732-1972 (hereinafter: "**The Telegraph Ordinance")**, regulates the use of the electromagnetic spectrum, and applies, *inter alia*, to the use made by Pelephone of radio frequencies, as part of its infrastructure. The set-up and operation of a system making use of radio frequencies is subject, under the Telegraph Ordinance, to the issue of a license, and the use of radio frequencies is subject to designation and allocation of a suitable frequency. The Telegraph Ordinance imposes license fees and fees for designation and allocation of frequencies.

For several years, the Government has been coping with the existing shortage of radio frequencies for public use in Israel (*inter alia*, due to the allocation of a great many frequencies for security uses), by limiting the number of licenses issued for the use of frequencies, on the one hand, while increasing fees payable in respect of the allocation of a low range frequency on the other.

The Wireless Telegraph (Licenses, Certificates and Fees) Regulations 5747-1987, stipulate various fees for business stations (including MRT business stations), MRT, point to point wireless lines, satellite stations etc. For the allocation of radio frequencies to Pelephone, see section 3.10.2 above.

3.18.1.3 Facilities emitting electromagnetic radiation

3.18.1.3.1 Existing regulations

The Pharmacists (Radioactive Elements and Products) Regulations 5740-1980, regulate, *inter alia*, relate to electromagnetic radiation in facilities emitting such radiation, and they are applicable to some of Pelephone's facilities. The setting-up of such a facility and such activity are subject, *inter alia*, to a permit from the Commissioner for Environmental Radiation at the Ministry of the Environment, and the Commissioner is entitled to render the issue of a permit contingent on certain conditions, both for the issue thereof and for the validation thereof post-issuance. The Commissioner is also entitled to issue directives as to the adoption of appropriate measures such as he may enumerate, if he is of the opinion that the facility is liable to jeopardize the health or wellbeing of an individual or the public or the environment. Non-fulfillment of the regulations or the terms of the permit or the Commissioner's directives is cause for revoking or suspending the permit.

3.18.1.3.2 Legislation

On December 20, 2005, the Non-Ionized Radiation Law 5766-2005 was passed, the commencement of which, for regulating radiation licensing, was set down for January 1, 2007. The provisions of the Law require a re-examination of the Company's preparations regarding compliance with the conditions of the Law, a process which is due to be completed during the course of this year.

3.18.2 Controlled tariffs

Payments for interconnectivity:

The Telecommunications (Payments for Interconnectivity) Regulations 5760-2000 (hereinafter: the "**Regulations**") prescribe limitations regarding payments to be made or to be received from a domestic carrier or another MRT carrier under the Regulations. The tariffs for incoming calls to cellular telephones were scaled down gradually from October 2000 to January 2003. In December 2004, the following regulations were made:

A. For the purpose of interconnectivity payments received from a domestic operator or from another MRT operator for completion of one traffic minute on an MRT network, the current tariff for call completion is to be scaled down gradually to NIS 0.22 in accordance with the following outline (tariffs do not include VAT):

1. As of March 1, 2005, the current tariff of NIS 0.45 per traffic minute will be reduced to a maximum tariff of NIS 0.32.
2. As of March 1, 2006, the tariff will be reduced to a maximum tariff of NIS 0.29.
3. As of March 1, 2007, the tariff will be reduced to a maximum tariff of NIS 0.26.
4. As of March 1, 2008, the tariff will be reduced to a maximum tariff of NIS 0.22.

B. With respect to payments received from an international licensee for completion of traffic on an MRT network, the current tariff of NIS 0.25 for call completion will be reduced, as of March 1, 2008, to a maximum tariff of NIS 0.22.

C. With respect to payments received from another MRT operator for the transmission of a short message (SMS) on an MRT network, the current tariff will be reduced, in two stages, so that as of March 1, 2005 the current tariff of NIS 0.285 per SMS will be reduced to a maximum tariff of NIS 0.05, and as of March 1, 2006, the aforementioned tariff will be reduced to a maximum tariff of NIS 0.025.

D. The tariffs in paragraphs (A) to (C) above will be revised once a year, commencing March 1, 2006, in accordance with the rate of change of the Consumer Price Index.

E. For the purpose of calculating payment for call completion to an MRT network, as of January 1, 2009, the charge will be made in accordance with segments of one second (unlike the current charging system which enables charging per segments of up to 12 seconds). Consequently, as of January 1, 2009, the payments payable by the MRT operator for interconnect services to a domestic operator's network will also be revised.

F. Later, the Ministry of Communications intends to examine whether there are justifiable grounds for enabling MRT operators to collect initial payment in respect of the creation of a call.

G. During the past few months, a hearing took place concerning the intention to restructure the tariff to the consumer for an MRT call in such a way that, as of a reasonable date to be determined, the call price will not distinguish between an intra-network call and a call from an MRT network to another network, and the price will also include the interconnectivity component. This matter was examined by a joint team from the Ministry of Communications and the Ministry of Finance, with the assistance of Prof. Reuven Gronau. No official decision has been made in this regard.

The following table itemizes tariff development:

	To Sept. 2000	**From Oct. 2000**	**From Jan. 2002**	**From May 2002**	**From Jan. 2003**	**From May 2004**	**From Mar 2005**	**From Mar 2006**	**From Mar 2007**	**From Mar 2008**
Linkage – Domestic (tariff per minute)	62.0	54.0	50.0	50.0	45.0	45.0	32.0	29.0	26.0	22.0
SMS message	–	–	–	38.0	38.0	28.5	5.0	2.5	2.5	2.5
Linkage – International (tariff per minute)	62.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	22.0

Note: Tariffs are set out in agorot. Prices are rounded off and do not include VAT.

In recent months, a hearing was held in writing and orally regarding the interconnect tariffs for all cellular carriers, and as at the date of publications of these reports, Pelephone is waiting for a decision to be made by the Ministries of Finance and Communications.

3.18.3 License and site licensing

3.18.3.1 Pelephone's license

The General License for the provision of MRT services granted to Pelephone on February 7, 1996 was for a period of 10 years commencing January 1, 1994, with an option of extending it for additional periods of 6 years each, under the conditions set forth in the license, consisting primarily of compliance with statutory conditions. Following the tender in which 3rd generation frequencies were allocated to Pelephone the license was expanded in such a way as to be valid for a period of 20 years commencing September 9, 2002.

(For the arrangement with the State of Israel concerning right of use of frequencies, see Note 8D to the Company's financial statements for the year ended December 31, 2005, included in this periodic report).

Likewise, in April 2001, the Civil Administration for the Judea and Samaria Region awarded Pelephone a general license for the provision of mobile radiotelephone services by the cellular method (MRT) in the region of Judea and Samaria, applicable to which (with some changes) are the provisions of the General License awarded to Pelephone by the Ministry of Communications.

The following are the principal provisions of Pelephone's license (hereinafter: in this Section – the licensee):

A. Under certain circumstances, the Minister is entitled to modify the conditions of the license, to restrict it or to suspend it, and in certain instances to revoke it.

B. The license is non-transferable, and neither may 10% or more of any means of control in the licensee be transferred either directly or indirectly, nor may any means of control in the licensee or any portion of any means of control be transferred in any manner in such a way as to confer control ion the licensee, nor may control in the licensee be acquired, either directly or indirectly, unless the Minister shall have given his consent beforehand.

C. A shareholder in Pelephone or a shareholder in an interested party therein may not charge his shares in such a way that realization of the charge will result in a change of ownership of 10% or more of the means of control in the licensee, unless the agreement contains a provision whereby the charge may not be realized except with the prior consent of the Minister.

D. The licensee shall take steps to establish interconnectivity of the network to another public telecommunications network in the State of Israel (including towns, military sites, and military bases in the areas of Judea and Samaria and the Gaza Strip). The licensee is obliged to provide interconnect service on equal terms to any other operator and must refrain from any discrimination in implementing interconnectivity

E. The licensee shall refrain from awarding preference in the provision of infrastructure services to a licensee being a company with an interest[12] over another licensee, whether for the payment for the service, whether in the conditions of the service, whether in its availability or otherwise.

F. The licensee is not entitled to sell, to lease or to mortgage any of the assets used for the implementation of the license without the consent of the Minister of Communications, except for:

   (1) Charging of any of the licensee’s assets in favor of a banking corporation duly operating in Israel, for the purpose of obtaining bank credit, provided that notice shall have been served on the Ministry of Communications regarding the lien proposed to be made, whereby there is included in the mortgage agreement a clause ensuring that realization of rights by the banking corporation will not, in any event, result in any damage whatsoever to the provision of the services pursuant to the license.

   (2) Sale of items of equipment during an upgrade procedure, including sale of equipment by the trade-in method.

G. The director (under the license: the Director-General of the Ministry of Communications) or whoever he shall have empowered for the purpose of the license, is entitled to issue directives concerning numbers mobility such that any subscriber of another MRT licensee may transfer to and become a subscriber of the licensee or receiving services from the licensee without changing his telephone number, and vice versa, and in such case, the licensee must incorporate into its telecommunications

[12] "Company with an interest" - as defined in the Telecommunications (Processes and Conditions for Obtaining a General License for the Provision of Domestic Fixed Line Telecommunication Services) Regulations 5760-2000. These Regulations define a company with an interest as "a parent company, subsidiary, sister company, interested company, affiliate, related company or partner company" and each of these terms is defined in the Regulations.

network devices enabling the application of such feature, as instructed by the director.

H. During states of emergency, whoever shall have been statutorily empowered therefor shall have the authority to issue the licensee with certain instructions as to its mode of operation and/or mode of provision of services.

I. The license sets forth the types of payments that the licensee is entitled to collect from its subscribers, the mechanisms of setting tariffs, the reports the licensee is obliged to submit to the Ministry of Communications and also the duty of serving notice on the Ministry of Communications prior to modifying tariffs. The license also determines the Minister's power to intervene in tariffs, in certain cases.

J. The license commits the licensee to a minimal standard of service, including setting up of service call centers, the determination of a maximum period for repair of malfunctions, an accounts collection procedure, protection of the privacy of the recipient of the service and so forth.

K. To secure the licensee's undertakings and also in order to compensate and indemnify the State of Israel in the event that it sustains damage due to acts of the licensee, the licensee must furnish a bank guarantee in the amount of $20 million. The license determines the instances in which such guarantee maybe forfeited.

Royalties

Pursuant to its license and to the Bezeq Regulations (Royalties), 5761-2001, Pelephone pays the State of Israel royalties at a rate of 3.5% of its revenues from the provision of telecommunications services net of income and expenses specified in the Regulations, foremost among which are: income from interconnections, payments transferred to the owner of a foreign MRT operator for roaming services, revenues from sale of terminal equipment and bad debts relating to income respecting which royalties were paid. In the year 2001, the rate of royalties was 5%, in 2002 – 4.5%, in 2003 – 4%, and in 2004 the rate of royalties was reduced to 3.5%. According to a letter received on December 5, 2004 from the Ministry of Communications, the Minister of Communications and the Minister of Finance intend to amend the Telecommunications (Royalties) Regulations in such a way that as of January 1, 2006, there will be an annual decrease of 0.5% in the rate of royalties, until such is reduced to 1%.

For the purpose of implementing the above, the Ministries of Communications and Finance intend to apply to the Finance Committee of the Knesset to amend the Royalties Regulations accordingly.

Regarding a lawsuit filed by the State of Israel against Pelephone with respect to non-payment of royalties, see Note 19A(26) to the Company's financial statements for the year ended December 31, 2005, included in this periodic report.

3.18.3.2 Site licensing

Pelephone's MRT service is provided, *inter alia*, through cellular sites spread over Israel in accordance with engineering requirements. The constant need to upgrade and improve the quality of the MRT services necessitates setting-up the cellular sites, or changes in configuration or changes in existing antenna systems.

The erection and operation of cellular antenna necessitates building permits from the various planning and building committees, a procedure requiring, *inter alia*, a number of approvals from Government concerns and regulatory bodies, including:

A. Approval for erection and operation from the Ministry of the Environment (See Section 3.17.1 above)

B. Approval of the Civil Aviation Administration in some cases.

C. Approval of the IDF.

Pelephone (and its competitors) encounters difficulties in obtaining some of the required approvals, and in particular approvals from planning and building authorities.

Pelephone's ability to maintain and preserve its MRT service quality and also the coverage, is based partly on its ability to set up cellular sites and to install infrastructure equipment, including broadcasting sites. The difficulties encountered by Pelephone in obtaining the required permits and approvals may adversely affect the existing infrastructure, the network's performances and the setting-up of any additional cellular sites required by the network.

The inability to resolve these problems on a timely basis is even liable to prevent the attainment of the service quality goals specified in its license.

A number of sites established several years ago still do not have approvals from the Civil Aviation Administration and the IDF, even though the applications for the approvals have long since been in the hands of those authorities. Similarly, administrative or other delays occur in some planning and building authorities in the issue of building permits for sites. Accordingly, Pelephone (and also its competitors) operate a number of broadcasting sites for which building permits have not been issued. Applications for the building permits have been filed by Pelephone with the planning and building authorities, and are at various stages of discussion and approval.

The erection of a broadcasting site without obtaining a building permit constitutes a breach of the Planning and Building Law, 5725-1965, and in some instances, this has resulted in the issuance of demolition orders against sites or the filing of indictments or the adoption of civil proceedings against Pelephone and some of its office bearers.

As at the date of this report, Pelephone has in most cases succeeded in making arrangements in respect of the deficient licensing, in avoiding demolition or in delaying execution of demolition orders pursuant to arrangements reached with the planning and building authorities. These arrangements have not necessitated any admission of guilt, and/or conviction of office holders acting on behalf of Pelephone. However, it is not certain that this state of affairs will continue in the future, or that there will be no further instances in which demolition orders are issued or indictments filed in respect of building permits, including against office holders.

Pelephone, like Israel's other MRT operators, is liable to be required to dismantle broadcasting sites for which the necessary approvals and permits have not been obtained. If a demand is made for the simultaneous demolition of sites in a given geographic area, service in that area is liable to deteriorate, until substitute broadcasting sites can be built.

Likewise, Pelephone, like Israel's other MRT operators, provides internal relays inside buildings in order to provide service in the buildings. These relays are miniature installations connected to an outside antenna about 60 cm in size. This antenna facilitates the reception of a broadcasting signal from a nearby broadcasting site, which is then "relayed" to within the building. The radiation emission from these miniature antennae is similar to the radiation emitted by cellular terminal equipment. These relays have been accorded a classification approval by the Ministry of Communications.

Given the planning authorities' lack of clarity in policy matters relating to internal relays, and the work patterns of all of Israel's MRT operators, permits were not sought from the planning authorities in respect of these internal relays.

The Ministry of the Environment is preparing a procedure for the issue of permits for the setting-up and operation of broadcasting facilities of the same class ("class permit") the purpose of which is, *inter alia*, to simplify the licensing process of miniature installations and internal relays.

If the planning authorities decide that permits are also required for the installation of facilities of this type, such decision could negatively impact the installation of such facilities.

What is more, on December 20, 2005, the Non-Ionized Radiation Law, 5766-2005 was passed by the Knesset, the commencement of which, with respect to the regulation of radiation licensing, has been set down for January 1, 2007. Implementation of the provisions of the Law and the procedures that are to be prescribed under it will require Pelephone to make appropriate arrangements. In addition, the very fact that issue of operation permits under the Law is dependent upon a building permit will constitute yet another obstacle on the road to delaying the work involved in making the network compliant as set out above.

3.18.3.3 Set-up of Communications Facilities – National Outline Plan 36

The National Outline Plan for communications (hereafter: "**NOP 36**") was designed to regulate the spread and manner of setting-up of communications facilities in order to secure the functioning thereof, with full coverage of the State territory, for radio, television, and wireless communications transmission and reception, while minimizing damage to the quality of the environment and the landscape.

NOP 36A is supposed to simplify and streamline the setting-up processes of miniature and small broadcasting facilities. It stipulates clear obligations and guidelines and creates a uniform framework for processing permit applications. Approval of NOP 36A did not give rise to the regulation desired and many planning authorities have complained about the provisions of the plans, and principally, with regard to the following two matters:

- Removal of the planning discretion in their regions;
- Exposure of them to claims due to reduction of value under Section 197 of the Planning and Building Law, and failure to impose an obligation on the cellular companies to indemnify the committees for claims that might be made against the planning authorities.

This state of affairs caused no end of discussions between the cellular companies and the planning committees, which brought with it a multitude of claims in this area. Likewise, the planning committees have set out on an active trek to move to amend NOP 36A.

As a result of that, on February 1, 2005, the National Planning and Building Council adopted the following resolution:

(1) No building permit shall be issued unless the applicant for a permit deposits a deed of indemnity with the local authority in respect of compensation pursuant to Section 197 of the Planning and Building Law, to cover such compensation as the committee may be ordered to pay. Section 197 of the Planning and Building Law confers on landowners injured by a plan applied on their land or on neighboring land the right to compensation from the local committee. The described amendment of NOP 36A is liable to subject Pelephone to an inconsiderable financial obligation in respect of the decrease in value of properties as a result of the positioning of cellular antennae adjacent thereto. However, at this stage, there is no certainty as to either the obligation or the extent thereof, and they will not, of course, result automatically from the decision of the national council to amend NOP 36A.

(2) Further to the directives of the National Council as at August 3, 2004, the drafting committee will formulate an amendment to the NOP with respect to extension of the local committees' discretion, and notification of the public.

(3) When the draft resolution concerning extension of the discretion of local committees is submitted to the Council, the possibility of changes in the indemnification obligation and the extent thereof will be examined.

All the aforementioned resolutions are subject to Government approval.

On July 24, 2005, the government of Israel resolved to defer approval of the resolution of the National Council for Planning and Building to amend National Outline Plan 36A dealing with the setting up of small and miniature broadcast facilities for the time being. The amendment revolved around expansion of the discretion of local committees, provision of objection rights to the public and requiring companies to deposit undertakings to indemnify the planning committees for claims of devaluation of land. The cellular companies' portion of this indemnification was budgeted at 80% of the value of the devaluation and the balance is supposed to be borne by the local committees. The aforesaid postponement is intended to enable the committee of CEOs that was set up, to submit its conclusions within three months. The Committee submitted its conclusions to the government, which set out its recommendations, the main ones being:

– Creating a distinction between small and large sites, the licensing process for small sites being either via an exemption from license track or a fast licensing track, whilst for large sites, a complex licensing process will be required, including giving the public the opportunity to express its objections.

– A distinction is to be made between small and large sites with respect to the amount of indemnity required on the basis of the principle that: The greater the discretion of the planning authority and the integration of residents in the objection process, the greater the rate of indemnity.

– Likewise, implementation of the committee's recommendations requires an amendment to the Planning and Building Law, and therefore, it is not possible to estimate the timing of the end of this process. At the same time, the recommendations of the CEO Committee have been submitted to the National Council for the purpose of examining the integration of such recommendations into the National Outline Plan.

At the same time as all this, the Knesset has conducted a comprehensive amendment of the Planning and Building Law, as part of the Non-Ionized Radiation Law, under which it imposed an obligation to provide indemnity as a condition for the grant of a building permit, provided that such requirement is in accordance with the guidelines of the National Council which may be in force until provisions in this regard are set out in the National Outline Plan.

The National Council resolved, as an interim measure, to impose an indemnity obligation at a rate of 100% on the cellular companies, until any other prescription is made under NOP 36.

This state of affairs will have severe implications on the ability of the cellular companies (including Pelephone) to develop their networks, and the existence of an indemnification obligation will impose an inestimably heavy economic burden on them.

In recent weeks, the drafting committee of the National Council has held a series of discussions in order to formulate its recommendations for the Council's plenum regarding amendment of NOP 36, including the issue of indemnity and the rate thereof.

3.18.4 Standards

Pelephone conducts routine durability and quality control tests of its facilities. The quality control and supervision do not detract from Pelephone's responsibility towards its customers for the quality of the services it provides.

In April 1996, the Israel Standards Institute found Pelephone to be in compliance with the requirements of Israel Standard ISO 9001 2000 edition, in the field of mobile radio telephone (cellular) services.

The certificate was awarded on January 11, 2004, and is valid until January 31, 2007.

ISO 9001 2000 edition consists of a series of standards for quality management in the services. This is a standard for quality control systems that defines requisite conditions for compliance with service process standards and also constant improvement and testing of the efficacy of the quality management system and its components.

Pelephone carried out the required adjustment for obtaining the approval in line with the tendency of the business-industrial world in general and the tendency of its customers in particular, to contract exclusively with suppliers meeting the requirements of the Standard.

3.19 Legal Proceedings

See Note 19 to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

3.20 Business Strategies and Goals

3.20.1 Pelephone's principal strategic goals are:

(1) Improve profitability;

(2) Lead with third generation technology;

(3) Create valuable brands in the field of mobile entertainment and in the private and business sector.

(4) Increase market share;

3.20.2 Marketing strategy

As part of its marketing strategy regarding the activity of two distinct brands, in 2004 Pelephone completed a comprehensive strategic measure that included the launch of a special-purpose brand leading the youth and mobile entertainment arena, and the repositioning of the Pelephone brand for the private and business sector.

The youth brand was created on the basis of the concept that the use of the cellular telephone was about to evolve away from being merely a mobile phone and towards being a mobile entertainment platform.

Esc was launched in January 2003, in a comprehensive marketing drive, all of the components of which hinge on the same values of differentiation, boldness, innovativeness, entertainment and a youthful spirit. A cellular portal was accordingly constructed, Israel's first cellular concept retail outlet was established, an advanced internet site and later Radio Esc99 were set up. By the end of the first year, over one hundred thousand customers had joined. Today, Esc has more than 400,000 customers.

The repositioning of the Pelephone brand – while forming its marketing strategy, Pelephone identified an unsatisfied need among its target public for a simple and practical personal approach, devoid of extravagant promises.

Therefore, the Pelephone brand has been repositioned based on the values of: Simplicity, fairness, flexibility and innovative empowerment.

3.21 Development Outlook for the Coming Year

During 2006, a number of factors are expected to affect Pelephone's activities, the principal ones are as follows:

3.21.1 Continued reduction of interconnectivity fees

As noted in sub-paragraph 3.18.2, connectivity fees were reduced on March 1, 2006 from 32 agorot (excluding VAT) to 29 agorot (excluding VAT). Connectivity fees will subsequently continue to be scaled down annually, reaching 22 agorot (before VAT) on March 1, 2008. The reduction of connectivity fees is expected to adversely affect Pelephone's revenues, but Pelephone estimates that tariff revisions will help reduce the adverse effect.

3.21.2 3rd generation services

In September 2004, Pelephone launched the 3rd generation EVDO network, enabling data communication at a rate of up to 2MBps. Pelephone estimates that it will succeed, thanks to this move, in securing a competitive edge. 3rd generation services are expected to yield Pelephone additional revenues and to increase income from customers. At the beginning of 2006, Pelephone has more than 70,000 3rd generation customers. The Company intends to continue penetration amongst its customers, and to continue distributing 3rd generation handsets.

3.21.3 Innovative added value services

In 2006, Pelephone is expected to continue to launch a diverse range of advanced added value services that will help improve the perception of the brand and increase revenues from existing customers. Prime examples are the PTT (Push To Talk) services that will enable new subscribers to be recruited in a market segment that was hitherto inaccessible to Pelephone (primarily MIRS subscribers) and AGPS (location based) services, which will secure Pelephone a competitive edge and will enable a diverse range of services to be launched for the private and business sector.

This section 3.21 includes forward-looking information. Forward-looking information is uncertain information concerning the future, based on information available to Pelephone on the reporting date, and including Pelephone's assessments or intentions as at the reporting date. Circumstances liable to lead to non-realization of the expectations described above may derive from market behavior, activity by the competition, mode of penetration of new services and technological difficulties.

3.22 Risk Factors

A. Increasing competition

Four companies operate in Israel's cellular market. The market is characterized by high saturation, fierce competition among the companies finding expression in, *inter alia*, an ongoing reduction of tariffs and the large-scale transfer of customers between the companies.

B. Investments in infrastructure and technological changes

The cellular market in Israel and elsewhere is characterized by material capital investments in the deployment of infrastructure and in subscriber equipment.

The frequent technological changes in the field of infrastructure and terminal equipment, and also the fierce competition over various market segments, impose a heavy financing burden on the companies operating in the market, which necessitates updating their infrastructure technology from time to time or to penetrate new appliances into the market at heavy cost.

C. Market Risks

Pelephone is exposed to market risks a result of changes in interest rates, exchange rates, inflation, prices of infrastructure and subscribers' equipment.

The following is a detailed description of the market risks:

Dollar exchange rate - any change in the exchange rate of the shekel against the dollar itself constitutes economic exposure, since it may affect future cash flows and in particular repayment of foreign currency linked liabilities and payments for the acquisition of infrastructure and terminal equipment for subscribers.

Pelephone is also subject to accounting exposure deriving from the difference between rate of the change in the exchange rate of the shekel and the rate of change in the Consumer Price Index during the period of account. Due to this exposure, Pelephone is exposed to a decrease or increase in the value of foreign currency linked liabilities that could affect its real financing expenses.

Interest rate – From time to time, Pelephone takes shekel loans bearing variable interest linked to the prime rate (on call). This exposure may affect Pelephone's financing expenses and its cash flows. On the other hand, the fact that the interest rate is variable causes the fair value of these loans to approximate their book value.

Pelephone does not hedge against the exposures described above by entering into future interest rate transactions, but does take such effects into account in determining the type of loan. As at December 31, 2005, Pelephone has no loans of this type.

Inflation - the inflation rate affects Pelephone's operating income and expenses over the year. Pelephone does not have a tariff revision mechanism that is directly affected by the rise of the inflation rate. Pelephone does, however, adjust its tariffs from time to time at its discretion. The annual inflation rate and the breakdown thereof over the year may result in the material erosion of Pelephone's revenues. Pelephone's expenses are likewise affected by the inflation rate, with unlinked expenses such as payroll being eroded over the year, while acquisition costs, that are partly linked, do not change in real terms.

Pelephone's loans are linked to the "known index". The inflation rate creates exposure to higher principal and interest repayments.

Price of infrastructure equipment and subscriber terminal equipment – cash flows from Pelephone's activities are applied partially to investments in equipment. Equipment prices are influenced by changes in exchange rates and by international prices

Pelephone applies currency hedging in accordance with a policy established by the finance committee of Pelephone's Board of Directors.

The following are the guiding principles of exposure management:

1. Infrastructure investments - investments in long term projects backed by contracts with milestones are protected by means of forward transactions / options / dollar deposits.
2. Terminal equipment – hedging is done vis-à-vis invoices payable or open orders, taking into account existing inventory levels, in accordance with forecasted changes in dollar exchange rates.

D. Regulation of tariffs

Pelephone's connectivity fees are fixed by the Ministry of Communications and are subject to control and to changes that are liable to be made from time to time. The Ministry's decisions as to tariff changes may materially affect Pelephone's financial results. For a more detailed discussion of tariff development and control, see sub-paragraph 3.18.2 aforesaid.

E. Legal proceedings

Pelephone is party to legal proceedings, including class actions, which are liable to result in its being ordered to pay material amounts that cannot presently be estimated, and in respect of most of which no provision has been made in Pelephone's financial statements.

Pelephone is exposed to class actions. Class actions may reach high amounts, since approximately one third of the residents of the State of Israel are Pelephone consumers, and a claim relating to a small amount of damage to a single consumer may grow into a material claim against Pelephone if recognized as a class action applicable to all or a large proportion of those consumers. (for the legislative proceedings regarding class actions, see Section 2.16.10 above).

For legal proceedings to which Pelephone is a party, see Section 3.19 above.

F. Restrictions applicable to frequencies and disturbance in use of frequency range

At present, the volume of vacant frequencies that can be allocated to Pelephone over and above the frequencies it has in the CDMA range is limited.

The frequencies range used by Pelephone for operating the CDMA technology network is also used by land based television broadcasts, and part of the range is also used for cellular communications using GSM technology. Due to the use of those frequency ranges, broadcasts by a number of television stations transmitting in the Middle East cause disturbances in the operation of Pelephone's aforementioned network. In some cases, these disturbances have reached a level that prevents high quality CDMA-technology communication in parts of the Pelephone network.

Likewise, in light of the peace agreement with Jordan, Pelephone is precluded from making use of part of the frequency range that is suitable for the CDMA network, since the Jordanians use it for the networks they operate using GSM technology.

In addition, in the next few years, digital multi-channel television broadcasts are expected to evolve, transmitting a large number of compressed video channels, and this could aggravate the existing disturbances in the operation of Pelephone's CDMA network.

G. **<u>Electromagnetic radiation</u>**

Pelephone operates hundreds of transmission facilities that emit electromagnetic radiation (see Section 3.18.1.3 above). Pelephone is taking steps to ensure that the levels of radiation emitted by the aforementioned transmission facilities do not exceed the radiation levels permitted by the directives of the Ministry of Environment (levels adopted in accordance with international standards). Pelephone's third party liability insurance policies do not presently cover liability for electromagnetic radiation.

H. **<u>Site licensing</u>**

The set up and operation of cellular antenna are subject to building permits from the various planning and building committees, a process that involves, *inter alia*, obtaining a number of approvals from Government entities and regulatory bodies.

For details of the difficulties encountered by Pelephone in the setting-up and licensing of sites, see Section 3.18.3.2 above.

<u>Risk Factor Summary Table</u>

	Extent of effect of risk factor on Pelephone's operations		
	Large	**Medium**	**Small**
Macro Risks			
Exposure to changes in exchange rates		X	
Exposure to changes in interest rates		X	
Exposure to changes in inflation		X	
Sector Risks			
Increasing competition	X		
Investments in infrastructures and technological changes	X		
Tariff supervision	X		
Frequency restrictions and usage disturbances	X		
Electromagnetic radiation*			
Site licensing	X		
Special Risks to Pelephone			
Exposure to legal proceedings		X	

*** Pelephone is unable to assess the degree of effect of this risk factor on its activity.**

4. International Communications and Internet Services – Bezeq International Ltd. ("Bezeq International")

4.1 General

4.1.1 Structure and changes in area of operations

Bezeq International, a wholly-owned subsidiary of the Company, provides direct dialing services to some 240 destinations throughout the world. The international telephone services provided by Bezeq International, similar to the services provided by the other competing international operators, are based mainly on the Company's domestic network and on the cellular networks in order to connect subscribers to the international switchboard.

In addition to the international call services (hereinafter: "Voice Services"), Bezeq International provides data communications services (hereinafter: "Data Services") internet access services (ISP) (hereinafter: "Internet Services"), value-added services, telephony traffic routing services between foreign international communications suppliers and server and site hosting services (hereinafter: "Hosting Services"), and integration services under which the Company's business customers are offered total communications solutions (which include Data Services, Hosting Services and technical maintenance and support services for networks) (hereinafter: "Integration Services").

Data communications services provided by Bezeq International include point-to-point lines, frame relay, ISDN, ATM, virtual private networks, video conferencing facilities, and IP services.

4.1.2 Legislative and statutory restrictions applicable to Bezeq International

The Israeli communications market is regulated mainly by the Communications (Telecommunications and Broadcasts) Law, 5742 – 1982 (hereinafter: the "Communications Law") (see Section 4.17 below).

4.1.2.1 General license

Bezeq International operates pursuant to a general license for the provision of international telecommunications services (hereinafter in this chapter: the "License"), which is in force until 2022. The provisions of the License regulate, *inter alia*, the method of setting the tariffs which Bezeq International charges for its services, updates thereto and the collection of payments therefor.

4.1.2.2 Royalties

Pursuant to its License and the Telecommunications (Royalties) Regulations 5761-2001, Bezeq International pays the State of Israel royalties at an annual rate of 3.5%, on most of its revenues stemming from the provision of international call services and point-to-point lines, minus permitted expenses and except for revenues from the customers determined in said regulations.

In the past, Bezeq International conducted an investigation, as a result of which it emerged that the manner in which the royalties paid by Bezeq International had been calculated had been incorrect, and that in previous years its royalty payments had been too high. Bezeq International consequently updated its royalty payments. As at the date of publication of the periodic report, there is a dispute between Bezeq International and the Ministry of Communications regarding this update.

For the rate of royalties, see Section 2.16.3 above, regarding a letter from the Director General of the Ministry of Communications and the Deputy Commissioner for Budgets at the Ministry of Finance, dated April 20, 2005, regarding the anticipated gradual reduction of the rate of royalties.

4.1.3 Principal entry and exit barriers

4.1.3.1 The principal entry barrier to the international calls market derives from the need to receive a license pursuant to the Communications Law and implementation of infrastructure investments which are affected by frequent technological changes. However, a change in the licensing policy, as will be described below, and expansion of the use of VoIP technology in this sector are leading to significant reductions in the effect of these barriers.

4.1.3.2 The principal entry barrier to the data and internet services market stems from the need for investments in infrastructure (international capacity and access to the internet network and a broad service setup).

4.1.3.3 The principal exit barriers from these markets stem from long-term binding agreements with suppliers and investments requiring long repayment periods. In addition, Bezeq International is obligated to provide service to its customers throughout the period of its agreement with them.

4.1.4 Alternatives to Bezeq International products

The international calls market contains service suppliers which are not licensees (illegal operations), and consequently are not subject to the restrictions imposed on Bezeq International by virtue of the License and the provisions of the law. In addition, the use of VoIP technology enables the transfer of international calls on the internet network to other users of this technology and also to users of the TDM networks, by means of software products and overseas communications suppliers. The attractive usage tariffs for these services are bringing about a steady increase in the number of users and this results in harm to the revenues of Bezeq International.

4.1.5 Structure of competition in the sector and changes therein

In the first year of its operation, from June 1996 to July 1997, Bezeq International was the exclusive provider of international telephony services in Israel. In July 1997 two other international operators entered this arena: Barak I.T.C. (1995) - International Telecommunications Services Company Ltd. and 012 Golden Lines Ltd., and this led to a sharp fall in the prices of international calls and extensive growth in market volume. In April 2004 the Communications (Telecommunications and Broadcasts) (Procedures and Conditions for the Receipt of a General License for International Telecommunications Services) Regulations, 5764-2004 entered into effect. As at the date of publication of this report, the Ministry of Communications has granted general licenses for the provision of international telecommunications services to three more operators: Internet Gold-Kavei Zahav Ltd. (Internet Zahav), Netvision Ltd. and Xfone Communication Ltd., all of which started operations by the end of 2004. The expansion of competition has led to an additional fall in the prices of international calls, although, unlike 1997 when competition began, the volume of international traffic did not undergo a significant increase, since prior to the expansion of competition, call prices did not constitute a factor preventing the public from using the service. The above-mentioned expansion of competition had a negative effect on the results of Bezeq International's operation and on its financial condition, but since market prices have not yet stabilized, Bezeq International is unable to estimate, at this stage, the extent of the overall effect on the expansion of competition in the sector.

As at the date of the periodic report, licenses for the provision of Internet Services have been granted to some 70 companies, among them five of the aforementioned international operator licensees.

In December 2004, the Ministry of Communications permitted Bezeq International to provide fixed line telephony services over its internet network (VoIP) to approximately 8,500 customers, for a trial period of one year (which was extended to the end of August 2006).

On April 20, 2005 the Ministry of Communications gave notice of its intention to amend the main points of the policy it published concerning the licensing of the provision of telephony services by means of broadband access (VOB – Voice Over Broadband), in a way that will prevent Bezeq International (a subsidiary of the Company) from providing the service until the market share of the Company in fixed-line domestic telephony in a particular customer segment (business or private) falls below 85% or until another decision is made after examining competition in that field in November 2006 and in November 2007. This policy amendment, if adopted, is liable to oust Bezeq International from this developing market, thereby awarding its competitors in internet access and international dialing services (most of which have received experimental marketing licenses from the Ministry of Communications for providing these services and some are already operating in accordance with it) a clear competitive advantage in that they will be able to offer their customers a total communications solution combining access to the Internet, international telephony and fixed-line domestic telephony services. On February 7, 2006, the Ministry of Communications held a hearing in which Bezeq International was given an opportunity to make oral claims regarding the entry of the aforementioned policy amendment. Following the hearing, on February 8, 2006, the Ministry of Communications published a notice of its intention to ease the limitation on Bezeq International and to permit it to act in the field of VOB, under certain restrictive conditions. The inability of Bezeq International to offer a similar total solution in the event that, at the end of the day, it will not be allowed to provide VOB services, or substantial limitations are imposed upon it in this regard, might cause churn of existing customers in favor of the services of competitors, and might give rise to difficulties in getting new customers. Bezeq International is unable, at this stage, to estimate the effects of churn as aforesaid on the results of its operations and its financial condition. In this regard see also Section 2.6.1 above.

Implementation of the numbering and number portability plan (see Section 2.6.5 above) might require Bezeq International to make additional investments in infrastructure and equipment. Bezeq International cannot, at this stage, estimate the total extent of such investments.

4.2 Products and Services

Below are details of the principal products and services provided by Bezeq International:

4.2.1 Voice Services

In the Voice Services sector Bezeq International provides: International Direct Dialing (IDD) services to business and private customers; toll-free number services for business customers overseas; telephone card services enabling prepaid and postpaid dialing, mainly from overseas to Israel, for business and private customers; broadband telephony services (VOIP) on the basis of an experimental marketing license; and the 1809 service enabling dialing from Israel to overseas by dialing 1809. For this, see also Section 2.6.1 above.

4.2.2 Internet Services

In the Internet Services sector Bezeq International provides: internet access services to private and business customers, including terminal equipment and support, with an emphasis on fast broadband internet based on ADSL or cable infrastructures; Hosting Services – site storage and server services in a designated installation for business and private customers, including value-added services (such as monitoring and control); information security services, services securing customers' internet and LAN connections using the required terminal equipment or software, including monitoring; Data Services which include international data communication IP solutions for business customers, including global deployment if necessary; and wireless (WIFI) access – fast wireless access solutions for private and business customers, including in various public locations (hotspots).

4.2.3 Data Services

Provision of international data communication solutions for business customers, including global deployment in accordance with the customer's requirements.

4.2.4 Integration Services

During the third quarter of 2005, Bezeq International set up an Integration and New Business Department, whose operations shall focus on the fields of data, hosting (of servers and websites), and total integration solutions for businesses.

4.3 Revenues

Below are data of Bezeq International's revenues (in NIS millions):

	2005	2004	2003
Total revenues	817	816	703
Percentage of gross profit	35%	38%	38%

4.4 New Products

Following are descriptions of the principal new products launched in 2005:

4.4.1 Online file backup service for business customers.

4.4.2 Fixed-line VoIP domestic telephony services which were launched in a restricted format as part of an experimental marketing license granted to Bezeq International (see Section 2.6.1 above).

4.4.3 Hosted Exchange services – A managed e-mail service. The service is based on a model of providing remote managed solutions on the broadband infrastructure, which reduces a business's costs compared with the alternative of purchasing a server and licenses.

4.4.4 Mobile 014 services – This service enables convenient use of dialing from abroad to Israel from supporting cellular handsets, using a Bezeq International phone card.

4.4.5 Call Back service – A phone card service from overseas to Israel which enables the direction of a call to be reversed (Israel – overseas), thereby reducing costs.

4.5 Marketing, Distribution and Service

Bezeq International operates the following sales channels:

4.5.1 Recruitment center for internet and incoming voice call services providing solutions for demand, and recruitment center for internet and outgoing voice calls based on various files.

4.5.2 Retention center for internet and incoming voice call services providing solutions for customers wishing to leave Bezeq International and retention center for internet and outgoing voice call services which handles existing customers proactively.

4.5.3 National direct sales setup conducting “door to door” operations, operating points of sale and managing customers.

4.5.4 Distribution channel setup including external centers and field systems for resellers and dealers.

4.5.5 Yes@wow – a joint venture with DBS in which subscribers are recruited for integrated packages comprising internet access, multi-channel television, Company internet access infrastructure (for further details see also Section 5.16 below).

4.5.6 The marketing department coordinates all the operations for a number of permanent suppliers, among them advertising companies representing Bezeq International –which are used by Bezeq International to remain in contact with the various advertising media (television, internet, radio and the daily national press) – production and post-production companies (this changes depending on the requirements of each campaign), design and printing companies, and sales promotion and PR companies. Bezeq International believes that the loss of contact with any of its permanent advertising or marketing suppliers will have no significant effect on its marketing and distribution channels.

4.6 Competition

For the past few years Bezeq International has been engaged in fierce competition with the other international operators and internet suppliers, mainly those operating by virtue of a license granted to them by the Ministry of Communications, as well as with illegal operators (in the market for voice services). This competition has led to a steady erosion in the real prices charged by Bezeq International, and consequently in the volume of its revenues and average per-subscriber profitability. In the internet market the competition has generated significant growth in market volume and the addition of new subscribers. Expansion of competition with international carriers, as set out in Section 4.1.5 above, has adversely affected Bezeq International’s operations results and financial status.

4.6.1 Voice Services

4.6.1.1 In 2005 there were six competitors operating in the market: 014 Bezeq International (estimated market share 29%), 013 Barak (estimated market share 33%), 012 Golden Lines (estimated market share 27%), 015 Internet

Zahav (entered the calls market in August 2004 – estimated market share 7%), 017 Netvision and 018 Xfone (entered the calls market in December 2004, the market share of each of them is estimated at approximately 2%).

4.6.1.2 General characteristics of competition in 2005:

4.6.1.2.1 About 50% of households make international calls at least once a month.

4.6.1.2.2 The various sectors are extremely important (emphasis on immigrants originating from the former USSR) and marketing operations are designed accordingly.

4.6.1.2.3 The product is a commodity.

4.6.1.2.4 The market is a price market (perception).

4.6.1.2.5 Lack of involvement from consumers, leads to difficulty in recruitment and customer loyalty retention owing to inertia.

During the last quarter of 2005, Golden Lines 012 Ltd., the holder of an international license and a competitor of Bezeq International in the area of voice services, obtained a special general license to provide domestic fixed-line telecommunications services and a license to provide domestic transmission services, via 012 Telecom Ltd., a company incorporated by it. These licenses give Golden Lines a competitive edge over Bezeq International in supplying internet and voice services, mainly in the business customer sector, since it is able to offer its customers comprehensive communications solutions which include domestic communications.

With the entry of the new competitors and penetration of VoIP technology, competition is increasing. This increase is expressed in continued price reductions, erosion of profitability and decline in market share.

4.6.2 Internet services – Bezeq International@net

4.6.2.1 This market has five significant competitors: 014 Bezeq International (estimated market share 35%), Netvision (estimated market share 21%), Internet Zahav (estimated market share 16%), 012 Golden Lines (estimated market share 16%), and 013 Barak (estimated market share 12%).

4.6.2.2 General characteristics of competition in 2005:

4.6.2.2.1 72% of Israeli households are connected to the internet (90% of them have high-speed connections).

4.6.2.2.2 ADSL is the leading infrastructure (64% of high-speed internet connections)

4.6.2.2.3 In addition to image-promoting operations, the market is characterized by an aggressive campaign battle.

4.6.2.3 Developments in 2005:

4.6.2.3.1 Slow-down in rate of growth of high-speed internet compared with 2004.

4.6.2.3.2 Transition to broader access packages (1.5 Mb, 2 Mb and 5 Mb) – more than 50% of Bezeq International's customers are subscribers to access packages of 1.5Mb or more.

4.6.3 Solutions for the business sector – Bezeq International business

4.6.3.1 Products and services for the business sector

Voice services, internet services, data services, hosting services, information security services and integration services.

4.6.3.2 Bezeq International market segments in this sector (as estimated by internal surveys)

4.6.3.2.1 Calls – approximately 35%.

4.6.3.2.2 Internet (high-speed) – approximately 34%.

4.6.3.3 Characteristics of the business arena in 2005

4.6.3.3.1 Competitive parameters – service standards, range of solutions, technical capabilities, attractiveness of prices.

4.6.3.3.2 Aggressive battle for each customer and price erosion.

4.6.3.3.3 Emphasis on transition from sale of product to sale of total communications solution.

4.6.3.3.4 Cable company strengthening operations in business sector and launching solutions competing with those offered by the Company.

4.6.3.3.5 Increase of competition in the small and medium business (SMB) sector.

4.6.3.3.6 Small and medium businesses – transition from single-user solutions to network and security services solutions.

4.6.3.3.7 Large businesses – transition to IP solutions.

4.6.4 Coping with the competition

In order to cope with the competition in its area of business, Bezeq International has changed its cost structure, reduced the number of its employees, and at the same time made its customers a range of offers and reduced its service tariffs (*inter alia*, as part of its anchor country policy, as set forth in Section 4.21.1(E) below).

4.7 Seasonal Fluctuations

In general, the revenues and profitability of Bezeq International are affected in a minor way by the seasons of the year and holidays.

There are seasonal fluctuations in the following services:

4.7.1 Voice Services for the business sector – decrease in August and the Passover / Tabernacle holidays.

4.7.2 Voice Services for the private sector – increase in the summer months.

4.7.3 Internet services for the business sector – decrease in the summer months owing to the closure of educational institutions (customers in this sector are not billed for the Internet Services to which they subscribe in the summer vacation months).

4.8 Fixed Assets and Facilities

4.8.1 The international communication infrastructure constitutes an extremely material component in the total fixed assets of Bezeq International. International communications traffic is being transferred from and to Israel via underwater cable and international exchanges. Most of the communication volume is routed via the Med Nautilus and Lev cables the capacity of which is significantly greater that of the previous cables (Cios and Emos-I). Bezeq International has agreements with these cable operators. The most significant agreement is that with Mediterranean Nautilus Limited from March 26, 2001, regarding the purchase of capacity on the Med Nautilus cable. This cable connects Israel to Europe and then to the world (via continuation cables). The aim of the transaction was to supply the demand created for Bezeq International, mainly as a result of the growth in broadband internet, the need for significant international capacity, and consequently the dependence on this cable of Bezeq International which needs to provide its customers with Internet Services. The agreement with Med Nautilus enables Bezeq International to increase the capacity which will be at its disposal in accordance with its requirements from time to time, and Bezeq International therefore believes that in the near future there will be no lack of capacity to provide its customers with the full range of its services. In addition Bezeq International has agreements regarding the capacity of continuation cables which are used to transfer traffic to its final destination.

4.8.2 Towards the end of 2004, Bezeq International signed an agreement with Veraz, to purchase SoftSwitch switches which, during the course of 2005, replaced the Alcatel S-12 voice switches (which, at this stage, are still being used as a non-substantial component in the Company's voice service systems). These switches are used to route Bezeq International's voice traffic. The value-added services, including dialing cards, are based on an Intelligent Network (IN), which were also replaced in 2005 as part of the upgrade of its voice setup.

Bezeq International's technological infrastructures which support the voice, data and internet setups are deployed in four sites in order to provide services with high survival. During the course of 2005, the Company set up another site in London, England, via which advanced services are provided to its customers.

Bezeq International has long-term agreements for the lease of the main structures in which it is based, for average periods of 6 years.

4.9 Intangible Assets

4.9.1 License for the provision of Bezeq International services

Bezeq International operates within the framework of a general license for the provision of international telecommunications services, pursuant to the Communication Law, which anchors the right of Bezeq International to provide Internet Services. The license constitutes the basis for Bezeq International's operations.

4.9.2 Infonet

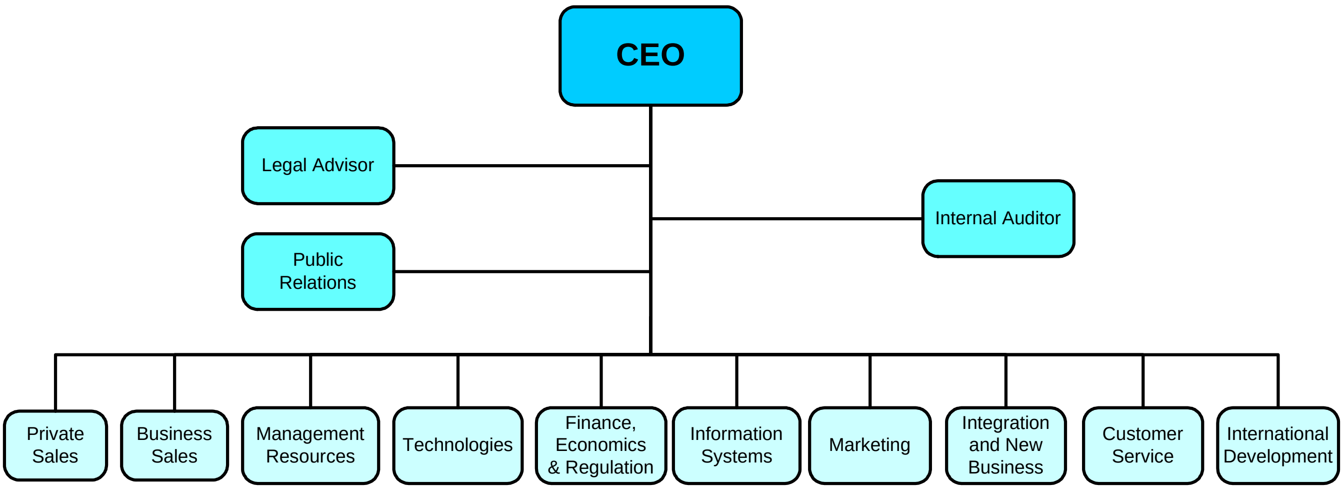
In December 2003 an agreement was signed by Bezeq International and Kardan Ltd. and Infonet Israel Ltd. (hereinafter: "Infonet"), whereby Bezeq International purchased the full rights to operate Infonet. As of April 2004, the results of Infonet operations are included in Bezeq International's results (see Section 4.18.2 below).

4.10 Human Capital

4.10.1 The number of employees of Bezeq International (company employees, personnel agency and outsourced workers) stands at 1,404, of which 286 are employed in headquarters (management, finances, management resources, marketing, information and technologies) and 1,118 are service and sales employees.

4.10.2 Organizational structure

Below is a chart depicting the organizational structure of Bezeq International:



4.10.3 Bezeq International has a number of employee groups whose wage structure includes a component of performance-linked commissions and incentives: sales employees, telephone sales representatives and telephone service and support representatives.

4.10.4 Employees have a leasing arrangement enabling employees to receive vehicles at a cost determined in accordance with the terms of an agreement between Bezeq International and a leasing company.

4.10.5 Bezeq International invests resources in professional training in accordance with the type of employee and the field in which he or she operates, such as: management reserve given to department managers and professional staff, negotiations and mediation, systems analysis, management skills, etc.

4.10.6 All of Bezeq International's employees have standard personal contracts based on their professions and positions.

For changes in the board of directors, see Section 1.3 above.

4.11 Suppliers

4.11.1 In February 2005 Bezeq International signed an agreement with SigValue for the purchase of an intelligent network system, the cost of which is not material. Bezeq International will be dependent on this provider.

4.11.2 Bezeq International has an agreement with Tadiran Information Systems Ltd. (which was acquired by IBM) which is implemented by IBM Global Services (Israel) Ltd. (hereinafter: "IBM") for the maintenance and development of service absorption and pricing and billing systems. Bezeq International is dependent on this service from IBM.

4.11.3 In 2004 Bezeq International set up a contact center (a system which integrates switchboard, a collaborative system comprising computer, switchboard and interactive voice response). This setup is used by Bezeq International's service, support and sales centers, and is based on the Avaya company technology. For this purpose Bezeq International signed a three-year agreement with IBM to provide ongoing support and maintenance.

4.11.4 Bezeq International has financial relations with some 100 foreign operators, in approximately 240 destinations worldwide. The substantial foreign carriers in terms of size and cost of traffic passing through them are: British Telecom, Rostelecom, Paltel, AT&T, etc.

4.11.5 Bezeq International is dependent on the international communication infrastructure provider Mediterranean Nautilus Limited, as described in Section 4.8.1 above.

4.12 Working Capital

4.12.1 Bezeq International's cash item includes bank deposits for immediate withdrawal as well as fixed-term deposits on which there are no usage restrictions and whose repayment date, on their investment date, does not exceed three months.

4.12.2 Bezeq International has negative working capital due to the classification of the Company's loans (see Section 4.15.3 below) as current liabilities. Bezeq International's surplus current liabilities over current foreign currency assets stemming from Bezeq International's contracts with foreign international communications carriers for the transmission of voice minutes and the purchase of data services (see Section 4.21A) was significantly reduced in 2005 as a result fo Bezeq International's operations to close old invoices with them, and this considerably improved the deficit in working capital to the situation where Bezeq International had a positive working capital, which was cancelled out as a result of the aforesaid classification.

4.12.3 Bezeq International's expenses for foreign international communication operators are based on estimates of business volumes. The balance of the overseas operators includes adjusted estimates and assessments of costs in connection with those overseas operators. The source of these adjustments and estimates is the final accounting for the period in question.

4.13 Credit Policy

4.13.1 Credit to customers

4.13.1.1 Most of Bezeq International's customers have credit terms of EOM + 45.

4.13.1.2 Equipment sold to customers is usually billed in 24 installments.

4.13.2 Credit from suppliers

Bezeq International receives credit from its suppliers for a period ranging from 30 to 120 days (usually 90 days).

4.14 Investments

As at December 31, 2005, Bezeq International held 42.85% (33.94% under full dilution as at December 31, 2005) of the share capital of Walla! Communications Ltd. (hereinafter: "**Walla**"), an Israeli company whose shares are listed for trading on the Tel Aviv Stock Exchange, and which deals in the provision of internet services and the operation of internet portals; that follows the exercise of option warrants (series 3) by the public during the fourth quarter of 2005. After the balance sheet date, and as at the date of publication of this periodic report, as a result of additional exercise of option warrants (series 3) by others, Bezeq International's holdings of Walla went down to 40.42% (33.66% under full dilution). The balance of Bezeq International's investment as at December 31, 2005 amounted to NIS 19.7 million, while its market value amounted to approximately NIS 88.3 million.

Walla recorded a profit for the first time in the third quarter of 2003. It finished 2004 with a net profit of approximately NIS 3.6 million, and it finished 2005 with a net profit of approximately NIS 12.3 million.

For additional details regarding Bezeq International's investment in Walla, see Note 8F to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report. Moreover, since November 2003, Walla's reports to the Israeli public can be found on the Securities Authority's Magna website.

4.15 Financing

4.15.1 As at the date of publication of this report, the Company has no liabilities to banking institutions and is not utilizing its approved line of credit.

4.15.2 Bezeq International registered a negative pledge in favor of banking corporations, under which it is prohibited from charging its assets without their approval.

4.15.3 The source of Bezeq International's finance in the past two years has been a positive cash flow from current operations.

Loans from the Company – during 2001 Bezeq International received from the Company non-interest-bearing, CPI-linked loans totaling $38 million whose balance as at December 31 2005 and 2004 amounted to some NIS 173 million and NIS 169 million, respectively.

On February 1, 2006, having received the approval of management of Bezeq International that Bezeq International is able to repay the loan without such harming the running of its business, the board of directors of Bezeq International resolved to bring forward the date of repayment of the loan and to pay the sum of the loan, linked to the CPI, back to the Company on February 14, 2006.

4.15.4 Bank guarantees – pursuant to the requirements of the Ministry of Communications, Bezeq International provided a bank guarantee in the sum of 2 million dollars and NIS 1.4 million, for the fulfillment of all of the conditions of the license for the provision of international telecommunications services; and NIS 322,500 for the fulfillment of all of the conditions of the experimental marketing license to provide VoIP services. In addition, Bezeq International provided further guarantees in the sum of approximately NIS 2 million for the performance of various undertakings to its business customers.

4.16 Taxation

See Note 11 to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

4.17 Restrictions on and Supervision of Bezeq International's Operations

4.17.1 <u>Legislative restrictions</u>

4.17.1.1 The Communications (Telecommunications and Broadcasts) Law, 5742-1982 and the general license for the provision of international telecommunications services.

Under the Communications Law, the implementation of telecommunications operations and provision of telecommunications services, including international telecommunications services and internet access services, require a license from the Minister of Communications. The minister is authorized to amend the terms of the license, add to them or detract from them, while taking into consideration, *inter alia*, the government's telecommunications policy, the interests of the public, the matching of the licensee to the provision of services, the contribution of the license to competition in the telecommunications industry and the level of service therein.

The Law authorizes the Director-General of the Ministry of Communications to impose financial sanctions for various violations of the provisions of the law and of orders and directives issued by virtue thereof, and for violation of the license terms.

A recently introduced amendment to the provisions of the Communications Law permits the Minister of Communications to prescribe those telecommunications services, the provision of which does not require a license. Pursuant to his declarations, the Ministry of Communications intends to exempt the provision of internet access services.

In view of said provisions of the Communications Law, all Bezeq International's telecommunications services are provided by virtue of the provisions of the license granted to it and pursuant to its terms, as set forth in Section 4.1.2 above.

4.17.1.2 Interconnectivity payments

The Telecommunications (Payments for Interconnect) Regulations, 5760-2000 (hereinafter: the "Regulations") regulate the payments made to the domestic operator or the cellular operator.

With regard to payments to be made by Bezeq International, as an international licensee, for the completion of traffic on a cellular network, the present tariff of NIS 0.25 for completion of a call will be reduced from March 1, 2008 to a maximum tariff of NIS 0.22.

The above-mentioned tariffs, rounded to 12 seconds, will be updated from March 1, 2006 in accordance with the percentage of the change in the CPI.

4.17.1.3 Royalties

For payment of royalties, see Sections 2.16 and 4.1.2.2 above.

4.17.1.4 Standards

Bezeq International is ISO 9001:2000 certified for quality management systems and ISO 7799 certified for information security management systems by the Israel Standards Institute.

4.18 Joint Venture Agreements

4.18.1 In April 1997 Bezeq International signed an agreement with the communications corporation Concert for the sale of data transfer services via Concert. The corporation was set up by British Telecom (BT) and the American company AT&T and also provides uniform communications services to multinational companies. During the course of 2002, the corporation wound up and the network is currently managed by BT. Bezeq International has an agreement for the distribution of BT's services in Israel, under which Bezeq International supplies FR technology managed network services, and IP based services.

4.18.2 In June 2003 Bezeq International signed an agreement with Infonet Corporation (hereinafter: "Infonet") for the distribution of Infonet's data communications services. Infonet is a network connecting many sites worldwide and provides for the efficient transfer of data between these sites. In December 2003 an agreement was signed by Bezeq International and Kardan Communications Ltd. for the acquisition of the operation of Infonet Israel Ltd., the Israeli representative of Infonet which provides international data communication and IP services on the Infonet network in Israel. The customer files were transferred to Bezeq International which received the equipment and rights to provide Infonet services in Israel, and it will provide technical support to all

Infonet's global customers requiring services in Israel. This acquisition process enables Bezeq International to serve as a franchisee and strategic partner of Infonet in Israel and provide its customers with an expanded deployment of global communication networks and access to a wider range of advanced, high-quality communication services.

During the first quarter of 2005, Infonet was acquired by BT, as a result of which a restructuring took place under which the infrastructure used by the companies to provide their services to Israel was unified. At this stage, neither the acquisition nor the restructuring have had any affect on the running of Bezeq International's business, nor on the sale by it of Infonet products.

4.19 Legal proceedings

4.19.1 On November 24, 1998, an equipment provider filed a claim in the Tel Aviv District Court against the Company and Bezeq International. The plaintiff argued that the Company and Bezeq International, jointly and severally, owe it some NIS 12 million owing to a violation of the agreement signed by the plaintiff and the Company in December 1995, the subject of which was the upgrading of an exchange.

Bezeq International, in its statement of defense, rejected the arguments of the plaintiff and even filed an application to dismiss the claim *in limine*. With the consent of the parties, the case was sent to conciliation proceedings. The conciliation proceedings were unsuccessful and the hearing was returned to the District Court. Preliminary discovery proceedings took place. The plaintiff filed an affidavit of evidence in chief on October 19, 2003, and an affidavit of evidence in chief was filed by Bezeq International on March 30, 2004. The matter is now in the stage of closing statements.

According to the advice of Bezeq International's legal counsel, a legal and factual analysis indicates that Bezeq International has good defense claims with respect to some of the supplier's allegations. Based on the above, and on understandings between the Company and Bezeq International as to the extent of Bezeq International's liability with respect to this claim, when finally ruled upon, management of Bezeq International assesses that the possibility that Bezeq International might be exposed to this claim is slim.

4.19.2 On April 4, 2004 a competing international communications operator filed a claim in the Jerusalem District Court against the State of Israel in the amount of NIS 11.2 million, for damages allegedly caused to it by a violation by the State of Israel of an obligation to place at its disposal part of the total capacity of an underwater cable (which was granted as part of the tender which opened the international communications market to competition in 1995).

On September 22, 2004 the State of Israel filed a statement of defense and third-party notice against Bezeq International and the Company. In the third-party notice the State argues that if the claim is accepted, in whole or in part, Bezeq International and the Company will have to bear all the consequences of any relief handed down against the State in the claim. The State further argues that Bezeq International acted in bad faith as a licensee toward the regulator in that it used capacity which had been earmarked for the other licensees. The State also makes similar arguments to the Company and also argues that Bezeq International, as a subsidiary of the Company, bears full liability alongside the Company for the Company's operations.

On December 20, 2004 Bezeq International and the Company filed a statement of defense to the third-party notice filed by the State in which they argued that the third-party notice should be dismissed, *inter alia*, because the claim and the third-party notice exceeded the period of limitation, that Bezeq International and the Company had acted in good faith, pursuant to the provisions of the agreements, which did not cause a violation of the agreements by the State, that they had protested that they would be unable to comply with the obligations contained therein and that they had not violated the provisions of the license. On December 30, 2004 the State filed a statement of response to said statement of defense.

The matter is in preliminary proceedings.

The legal counsel of Bezeq International believe that Bezeq International has good defense arguments against the claim and the third-party notice, among them arguments of exceeding the period of limitation and that there is a good chance that the third-party notice will be dismissed. However, especially in light of the preliminary stage which contains the third-party notice, the legal counsel of Bezeq International are unable, at this stage, to deny that the third party notice might be upheld, even in part, at the end of the day. Bezeq International has consequently decided not to include a provision for this claim in the Financial Statements.

4.19.3 On January 2, 2005 a claim was filed against Bezeq International, against two other international operators and against another company, in the amount of NIS 10 million, based on the argument that a patent for a prepaid telephone system had been infringed by persons alleging that they are the inventors and owners of said patent. According to the plaintiffs each of the defendants is infringing the patent which they own and unlawfully enriching themselves at their expense. In the statement of claim the plaintiffs demand that detailed reports of said revenues stemming from the infringement of the patent be submitted to them and that said full revenues, plus reasonable royalties and punitive compensation, be paid to them pursuant to the provisions of the Patents Law.

On April 20, 2005, Alcatel took over management of the defense in the case on behalf of Bezeq International in connection with one of the systems which are the subject of the claim (which it supplied), pursuant to the provisions of the agreement between Bezeq International and Tadiran Communications Ltd. dated December 13, 1998 (Alcatel is standing in lieu of Tadiran for the purpose of this agreement). On July 17, 2005, statements of defense on behalf of Bezeq International and a third party notice, against supply of an additional system operated by Bezeq International and used for the supply of the services under the Claim. The statement of defense filed by such supplier claimed, *inter alia*, that the systems supplied to the Company do not infringe the patent under the claim, and that the respondent supplier does not owe the Company anything based on the provisions of the Law and the agreements between the Parties.

Bezeq International's legal counsel are unable to quantify the changes and risks involved in this claim, at this early stage of proceedings; however, given the fact that Alcatel ahs taken responsibility for the results of the claim, as far as the system that it supplied is concerned, and that it is reasonably probable that the claim will be dismissed or that the third party served on the supplier of the second system will be upheld, and that in any event, it is not possible to reasonably estimate the sum that Bezeq International will be charged with in the event that the claim is upheld and the third party notice is dismissed, no provision has been made for this claim in the financial statements.

4.19.4 On February 27, 2005, Bezeq International's general license for the provision of international telecommunications services (the "license") was amended by the addition of an appendix which dealt with access to erotic services (services offered via a telecommunications installation containing messages with sexual content) via the international dialing services supplied by Bezeq International. Under the provisions of this amendment (clause 58A of the license, Bezeq International must block outgoing call access to any telephone number dialed without a dialing prefix prescribed by the Ministry of Communications for an erotic service (1919 prefix), to the extent that the Ministry of Communications has given it notice, or it has become aware in some other way, that an erotic service is being offered via such number. In reliance upon the findings of the Supervision Report, which the Director General of the Ministry of Communications views as arousing a real suspicion that Bezeq International is in breach of the abovementioned conditions of its license, the Director General of the Ministry of Communications gave notice to Bezeq International that he was considering imposing a financial sanction upon Bezeq International, in the sum of NIS 2,257,500, based on the right afforded to him under the Communications (Telecommunications and Broadcasts) Law, 5742-1982 (the "Law"), in the event of breach of a condition of the license. Pursuant to the provisions of the Law, Bezeq International was given an opportunity of making claims in writing, in response to the charges of the Ministry, by September 6, 2005. In its Supervision Report, the Ministry of Communications raises suspicions that Bezeq International entered into an agreement with a foreign carrier to the effect that it would transfer traffic to such carrier to fictitious destinations outside of Israel, intended, in effect, for the providers of erotic services operating in Israel, and that such operator would redirect such traffic to Israel via Bezeq International's international telecommunications system; such that the profits from these calls would be divided up between Bezeq International and the aforesaid foreign carrier. More seriously, at the center of its conclusions in the Supervision Report, the Ministry of Communications alleges that it can be held, in reliance upon the findings of its investigations, that: "Bezeq International was an active party to the provision of erotic services via its international telecommunications system, and that in respect of the period from 2004 until January 2005, the Company effected short termination redirection of calls, without such calls ever leaving the boundaries of the country."

On October 17, 2005, Bezeq International filed its response to the Director General's above notice to the Ministry of Communications, in which it claimed, *inter alia*, that: Bezeq International has never provided any form of erotic services, does not and did not have any commercial relations with suppliers of erotic content in Israel or overseas; Bezeq International has always been in strict compliance with the provisions of its license and the instructions of the Ministry of Communications and has acted effectively to block overseas destinations used for erotic services, to the extent that the Ministry of Communications has instructed it to do so; in any event, the Ministry of Communications has no real evidence that Bezeq International has breached the conditions of its license, and the charges against Bezeq International are based merely on groundless theories and baseless presumptions.

On February 13, 2006, the Ministry of Communications held a hearing in which Bezeq International was given an opportunity to make oral claims against imposition of the sanction. As at the date of this report, the decision of the Ministry of Communications regarding imposition of this sanction has not yet been obtained.

Management of the Company estimates that its arguments against the sanction are good and that it is unable to estimate the amount of the sanction if imposed. Therefore, the Company decided not to include this matter in its financial statements.

4.19.5 On the matter of the "industrial espionage" affair – On May 31 2005, three employees of Bezeq International were called in for questioning as part of the police investigation into industrial espionage by computerized means (a Trojan horse program). After being questioned, the employees were released with restrictions. Up to the date of publication of the interim financial statements, no proceedings have been instituted against Bezeq International and/or its employees relating to the above investigation. In this regard, see also Section 2.20.3 above and Note 19A(40) to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

4.19.6 For further updates on legal proceedings, see Note 19 to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

4.20 Goals, Business Strategy and Expected Development

4.20.1 As part of the preparations for 2005, Bezeq International set itself a number of key goals outlining the nature of its operations and reflecting the strategy which it adopted during the year:

4.20.1.1 Improvement and streamlining of its customer service setup.

4.20.1.2 Retention of average fixed income per-customer.

4.20.1.3 Development of alternative income sources for voice, internet and data.

4.20.1.4 Adaptation of expense structure to the new revenue levels.

4.20.1.5 Steady streamlining, *inter alia*, by defining indices and compliance with goals.

4.20.1.6 Focus on and retention of customer base.

4.20.1.7 Retention of leadership status via market share or leading margin.

4.20.1.8 Achievement of profitability in data sector, thereby justifying volume of operations.

4.20.1.9 Focused and differentiated operations based on value-added services.

4.20.1.10 Assimilation of SoftSwitch and IN without harming service standards.

4.20.1.11 Utilization of benefits deriving from IT investments.

4.20.2 Bezeq International's goals for 2006

4.20.2.1 Retention of the company's profitability.

4.20.2.2 Preparation for mergers in the industry and turning the threat into an opportunity.

4.20.2.3 Retention of the company's leadership status via market share or leading margin.

4.20.2.4 Progress on existing customer base, with emphasis on more efficient management of the churn prevention process.

4.20.2.5 Streamlining of customer service system and improving the Company's concept of service.

4.20.3 2005 was characterized by a continued increase of Bezeq International's operations in the field of supply of internet access services in general, and broadband internet in particular, including a variety of value added services and Datacom operations to international customers; in this way, Bezeq International continued its transition from an international call company to a global IP service carrier.

4.20.4 An additional area is Voice over IP in accordance with the marketing trial license Bezeq International received in December 2004. The trial is expected to continue, at this stage, until August 2006 and includes both private and business customers. As part of the marketing trial, Bezeq International will examine various scenarios for operation in the domestic calls arena. For the Company's position regarding this matter, see Section 2.6.1 above.

4.20.5 In 2005 Bezeq International improved its market position in all the areas of its operations. In the past year, Bezeq International put Infonet services into effect, having purchased the operations of that company so as to leverage its operations in the field of data.

4.20.6 In view of the intensifying market competition, observers believe that the market is likely to undergo consolidation processes, which will create merger and acquisition opportunities for the leading market players. Bezeq International will examine such opportunities as they are created based on their financial feasibility and on regulatory decisions, insofar as it will be permitted to do so.

4.20.7 During the course of 2005, Bezeq International completed the upgrade of the technological systems that support the provision of voice and internet services, in particular the SoftSwitch and the IN systems. This upgrade enables the Company to offer its customers advanced services.

4.20.8 In 2005, Bezeq International reinforced its customer service system, which provides service and technical support to its business and private customers, by increasing the support staff and by implementing designated technological systems (CRM, Contact Center). As a result of this improvement in the customer service system, the Company won a service competition held by the Israeli Center for Management, in the category of continued service.

4.20.9 The above information is forward-looking and as such is not certain and might not become reality, in whole or in part. The forward-looking information is based on information that Bezeq International currently has as at the date of publication of this report, and contains estimates made by Bezeq International, its work assumptions or intentions, as at the date of publication of this report. The actual results are likely to be materially different from the results estimated or inferred from this information.

Management's forecast is based on forecasts related to the continued recovery in the Israeli market, continued penetration of broadband technology and continued growth in the number of internet users.

The above forecast might not become reality at all or might become reality in part only, owing to a downturn in the Israeli economy which will reduce purchasing power in Israel, owing to regulatory changes liable to harm the ability of Bezeq International to provide solutions to existing or changing market requirements, and owing to all the other risk factors listed below.

4.21 Risk Factors

Changes in exchange rates, CPI and interest rates

A. Changes in exchange rates – the main currency used by Bezeq International is the shekel which is also its reporting currency. There is a special risk in the nature of Bezeq International's international transactions: most of its operations (sales) derive from Israeli customers. In addition, Bezeq International provides services to customers worldwide and collects the payments to which it is entitled in foreign currency, mainly in US dollars. In contrast, Bezeq International uses services from suppliers throughout the world and pays them for these services in foreign currency, mainly in US dollars. The changes in the exchange rates of the currencies in which Bezeq International operates against the shekel expose it to exchange rate differentials which are liable to harm its profitability by increasing finance expenses as well as its cash flow. To protect itself against currency exposure Bezeq International enters into hedging transactions and purchases other financial instruments.

   Changes in the CPI – Bezeq International is exposed to changes in the CPI, mainly in connection with CPI-linked loans it has received from the Company (see Section 4.15.4 above). However, the linkage of these loans to the CPI has no effect on the profitability of Bezeq International but on its shareholders' equity only since the total effect of the change is charged to the capital reserve following application of the regulations regarding treatment of operations between corporation and a controlling party thereof in the financial statements. The date of repayment of the above loan was brought forward, and it was repaid to the Company on February 14, 2006.

   Changes in interest rates – Bezeq International has immaterial exposure to changes in interest rates in connection with disputes with the Ministry of Communications as stated in Section 4.1.2.2 above.

B. Competition – for the effect of the competition on the businesses of Bezeq International, see Section 4.6. above.

C. Investments in infrastructures, technological changes and dependence on suppliers – see Section 4.11 above.

D. Government supervision and regulation – for the application of the provisions of the Law and licensing policy and their effect on Bezeq International, see Sections 4.1.2 and 4.1.3.1 above.

E. Anchor countries

   Bezeq International undertook, in an official price list, to provide the cheapest rates for 4 countries (USA, Russia, France, Argentina) by the end of 2005. In light of this, Bezeq International's revenues were adversely affected following an update of its competitors' price lists.

F. Transition to SoftSwitch and upgrade of the IN system

   In 2005 Bezeq International replaced the switch and upgraded its intelligent network system. As a result of this, there is still a danger of faults which might cause harm to service.

G. Legal proceedings

   Bezeq International is a party to legal proceedings, among them class actions which are liable to cost material amounts and cannot at this stage be estimated, and for most of which no provision has been made in the financial statements of Bezeq International and the Company. (for legislative proceedings regarding class actions, see Section 2.16.10 above).

   For legal proceedings to which Bezeq International is a party, see Section 4.19 above.

Risk Factor Summary Table

	Effect of Risk Factor on Bezeq International's Activity		
	Large	Medium	Small
Macro Risks			
Exposure to changes in exchange rates	X		
Exposure to changes in interest rates			X
Exposure to changes in inflation		X	
Sector Risks			
Increasing competition	X		
Investments in infrastructure and technological changes	X		
Government supervision and regulation	X		
Special risks for Bezeq International			
Exposure in legal proceedings	X		
Anchor countries		X	
Transition to SoftSwitch switches and IN	X		
Dependence on suppliers	X		

5. Multi-channel Television – DBS Satellite Services (1999) Ltd. (hereinafter: “DBS”)

5.1 General Information on Field of Activity

DBS, which trades under the name of “Yes”, provides its subscribers with multi-channel satellite television services. Founded on December 2, 1998, DBS has been providing the service since July 2000.

This service allows for the provision of multi-channel encoded digital television broadcasts and value-added services to subscribers who receive the broadcast at home via small antenna dishes from which broadcasts are transmitted to a domestic decoder in the subscriber’s home and connected to the television set.

Most of DBS’s income stems from subscription fees and additional payments made by viewers. As at December 31, 2005 DBS had 520,671 subscribers.

DBS is the only company currently operating in the satellite multi-channel television broadcasting sector, even though neither the law nor the license awarded to it grant it exclusivity.

5.1.1 Structure and changes in area of operations

In the field of multi-channel subscriber television broadcasting in Israel (hereinafter: the “field of broadcasting”), two entities operate: DBS and three main cable television broadcast corporations, which are in the process of merging into one single corporation, and which now already operate as a single entity in most areas of operation, including marketing of broadcasts, acquisition of content, branding of joint operations and operation thereof, under the brand name “HOT” (hereinafter: the “**Cable Companies**”). To the best of DBS’s knowledge, in February 2006, an agreement was signed for the merger of the Cable Companies, which agreement requires various consents.

The field of broadcasting is characterized by the broadcasts of Israeli and foreign television content to subscribers in the form of various broadcasting packages in return for subscriber fees and additional accompanying payments.

The field of broadcasting is characterized by extensive competition between DBS and the Cable Companies. They operate by means of broadcasting licenses awarded to DBS and the Cable Companies by the Minister of Communications.

5.1.2 Statutory restrictions and special constraints

The Communications Law requires that a broadcasting license be obtained in order to transmit satellite television broadcasts to the public. In January 1999 DBS received the above-mentioned broadcasting license by virtue of the provisions of the law and pursuant to the Telecommunications (Proceedings and Conditions for the Grant of a Satellite Broadcasting License) Regulations 5758-1998 (hereinafter: the “Broadcast License”).

The broadcast license granted to DBS is valid until 2014. Thereafter it may be renewed for additional six-year periods.

For additional licenses granted to DBS, see Section 5.8.1 below.

Operations in the field of broadcasting are subject to licensing and supervision by the Ministry of Communications, in aspects defined in the Law and the broadcast licenses (which relate, mainly, to matters relating to competition, consumers, and technical and engineering aspects). Operations in this field are also subject to the Ministry of Communications policy in various areas, which relate to or connect with DBS's current operations and fields in which it wishes to act, and which often have substantial affects on the operations of persons active in the field of broadcasting.

DBS’ and the Cable Companies’ broadcasting operations are also under the constant supervision of the Cable and Satellite Broadcast Council (hereinafter: the “Council”). The Council sets policy and makes rules regarding the content of broadcasts, the duty regarding original Israeli productions, the division of content into genres, broadcasting ethics, consumer protection and other matters in the area of broadcasting policy. The Council is also responsible for enforcing the various statutes relating to the field of broadcasting, for approving the channels that DBS wishes to broadcast, or to cease broadcasting, and is also authorized to amend the broadcast licenses of DBS and the Cable Companies under the conditions set out therein.

The Council has authority in the field of consumer protection, so that the setting of price lists, updating of price lists and offers to customers require its consent or the giving of prior notice (on the issue of DBS's activities being subject to legislation and to the supervision of the Ministry of Communications and the Council, see also section 5.14 below).

Changes may be made to the identity and nature of the persons supervising the operations of the players in the field of licensing and supervision of the field of broadcasting (including DBS's operations), at the initiative of the government, as follows:

A. On October 30, 2005, the government decided to unify the operations of the Council, the Council of the Second Authority for Television and Radio, the Second Authority for Television and Radio and the Public Broadcasts Regulation Board (which provides professional and legal services to the Council) into a single unified commercial broadcasting authority, which is to be responsible for the regulation of all commercial television and radio broadcasts in Israel. To the best of DBS's knowledge, a government Bill has been prepared which is supposed to regulate this matter, however, it has not yet been submitted for voting in the Knesset plenum.

B. To the best of DBS's knowledge, as at the date of this report, the government is looking into setting up a communications authority, which is to replace the Ministry of Communications and the authorities mentioned in section A above, and hold all of their powers, instead of the planned change as set out in section A above.

5.1.3 Developments in markets of the field of operations

During the course of 2005, demand from consumers and potential consumers to receive a "total service package" containing multi-channel television broadcasts and internet connection infrastructure services (at high speeds) developed as part of general developments in the field of communications. In DBS's opinion, this trend of increasing demand for a total service package is expected to increase and to include demand to include fixed-line telephony as part of the service package offered to potential television subscribers – demand which has recently begun to ebb (for the effect of this development, see also Section 5.6.5B below).

In August 2005, the government decided to require the Minister of Communications and the Minister of Finance to do all of the acts required such that no later than January 1, 2007, the television channels of the Israel Broadcasting Authority (Channel 1 and Channel 33), the commercial television channels (Channel 2 and Channel 10) and the Knesset Channel (Channel 99) would be distributed to the public freely, nationwide, via a terrestrial transmission service using digital technology, backed-up by a digital satellite system. As part of this discussion, various governmental authorities have been instructed to promote and implement the decision, and in this context, to publish a tender to select an entity to plan, set up and operate the terrestrial digital broadcast system, and the digital satellite distribution system. If the government decision set out in this sub-section is put into action, the broadcasts of these channels shall constitute a partial substitute for DBS's broadcasts. DBS has submitted its objection to the proposal to the Minister of Finance and the Minister of Communications, under which it has even requested to hold a hearing which. As at the date of publication of this periodic report, an oral hearing is being held for DBS, and it has been informed that a written hearing will be held on the issue. To the best of DBS' knowledge, as at the date of publication of this periodic report, the Ministry of Finance is preparing to draft a tender to select an entity to set up and operate the channel distribution system.

In addition, in August 2005, the government resolved to require the Minister of Communications and the Minister of Finance to do all of the acts required in order to enable the public, no later than January 1, 2007, to purchase a basic television services package from the multi-channel television companies (the cable and satellite companies) including connection to the distribution infrastructure of the Company's broadcasts, and reception of the television channels of the Broadcast Authority (Channel 1 and Channel 33), the commercial television channels (Channel 2 and Channel 10), the Knesset Channel (Channel 99), the Educational Channel (Channel 23) and the designated channels, without the consumer being required to purchase any other services from the multi-channel television companies. To the best of DBS's knowledge, legislative amendments relating to implementation of this decision have been included in the memorandum for the proposed Budget Law for 2006, which is to be submitted to the Knesset following the elections for the 17th Knesset. DBS applied to the Ministry of Finance asking to hold a hearing in this regard, and as at the date of publication of this report, negotiations are being held between DBS and the Ministry of Finance.

In DBS's estimation, exercise of any of the above government decisions might harm DBS's revenues.

5.1.4 Technological changes that significantly impact on the area of activity

5.1.4.1 Technological developments and changes which have taken place in the field of digital broadcasting currently enable the provision of "personal television" services, which include bi-directional services that enable reciprocal communications between the individual subscriber and the service provider, and immediate provision of the service individually selected by the subscriber. The principal service in this field at present (even in Israel) is the provision of television services upon the immediate demand of subscribers, also known as Video on Demand (hereinafter: "VOD services"). As at the date of this report, VOD services are only provided by the Cable Companies and this has a substantial effect on competition in the field of broadcasting (in this regard, see Section 5.6.5A below).

5.1.4.2 Around the world, internet television content transmission services known as Internet Protocol Television (IPTV) has begun to be developed. These are video broadcasts transmitted via the internet, without using existing cable or satellite infrastructure, which enables consumers to view television broadcasts (including VOD services) via the internet. Recently, IPTV services were launched in Israel as well, although at the date of this report, to a very limited extent. The development of this technology and these services is expected to significantly affect the field of broadcasting, which is currently based on broadcast infrastructure.

5.1.5 Critical success factors in the area of operations and changes therein

DBS regards the following factors as critical to the success of its operations:

5.1.5.1 Differentiation, innovation and originality in its broadcasting content compared with the broadcasting content of its competitors, the Cable Companies. These factors are reflected in the purchase of content, which includes current movies, documentary programs and many series containing unique and innovative characteristics, as well as in the initiation, production and purchase of original Israeli programming. For such purpose, ongoing investment is required in the area of purchase and innovation of the content of broadcast supplied to DBS customers.

5.1.5.2 Recently, a significant component of broadcasts, which is material to success in the field of broadcasting, is the ability to offer subscribers "personal" television services, in particular VOD services. This ability depends upon regulatory approvals and the enactment of statutes (see Section 5.6.5A below).

5.1.5.3 Differentiation at the customer service level provided to DBS subscribers by the customer support and customer service setup, which constitutes a critical success factor in DBS' ability to retain customers in a competitive market.

5.1.6 Principal entry and exit barriers

5.1.6.1 The principal entry barrier derives from the burdensome regulation prevailing in the broadcasting sector, including the duty to obtain a license and the duty to operate in accordance with the relevant provisions of the law, pursuant to the provisions of the various licenses and the conditions of them, as well as the continuous supervision by the Ministry of Communications and the Council (see Section 5.14 below).

5.1.6.2 An additional key entry barrier which derives in part from the above-mentioned barrier, is the enormous investment required from a competitor in the market in order to establish a public multi-channel broadcasting setup (including a broadcasting center and national infrastructure to receive satellite broadcasts and purchase satellite space segments or a nationally deployed cable infrastructure) and in order to broadcast and distribute content to the public in accordance with market requirements (see Section 5.1.5.1 above), and pursuant to regulatory requirements and restrictions.

5.1.6.3 Principal exit barriers from the field stem from long-term agreements with suppliers (see Section 5.10 below); the large investments which require long periods of time to obtain returns; obligations to repay loans taken from financial entities given the need for considerable investments and obligations to provide service to subscribers of the broadcast supplier for the term of the contract with them.

5.1.7 Alternatives to and changes in sectoral products

With respect to DBS's broadcast and service package offered to customers, the following services may be classified as alternative products:

5.1.7.1 The variety of territorial channels and other channels broadcast for free to the Israeli public. These channels include Channel 1 (belonging to the Israel Broadcasting Authority), Channel 2, the commercial Channel 3 ("Channel 10 Israel"), the Knesset channel, Channel 23 belonging to Educational Television, the Music Channel ("Channel 24"), the Russian-language channel ("Israel Plus"), and the Shopping Channel.

For the initiative to set up a land-based and satellite-based digital broadcasting array for distributing various channels, see Section 5.1.3 above.

5.1.7.2 Internet television services – Internet Protocol Television (IPTV) (see section 5.1.4 above). DBS views IPTV services as a partial alternative to its broadcasts.

5.1.7.3 Video and DVD libraries. DBS views these services as being alternatives to part of DBS's services.

5.1.8 Structure of competition in the areas of operation and changes therein

The field of broadcasting is characterized by competition between the Cable Companies and DBS, including with respect to the components of operation set out in Section 5.1.5 above. The concentrated and complex ownership structure in the areas of content, communications and infrastructure in Israel is likely to cause groups throughout the chain of production, packaging and supply of content to move into positions of control. The Cable Companies which, together with the corporations related to them, have a broad deployment of advanced broadband infrastructure, and in which other communications entities are party to ownership, market and sell a package of services including multi-channel television services, high-speed internet infrastructure, and fixed-line telephony. . Sale of the service page with these three types of communications services (known as 'triple play') whilst DBS does not offer a similar package, constitutes a principal component in differentiating the offer to potential subscribers.

DBS, by cooperating with the Company, sells a service package that includes the multi-channel television services provided by it, and the Company's high-speed internet infrastructure, thereby providing a partial response to the 'triple' service package sold by the Cable Companies (for this joint venture, see Section 5.6.5B below).

5.2 Products and Services

DBS provides its subscribers with a wide variety of channels: Approximately 105 different video channels, more than twenty radio channels, about 15 music channels, approximately __ service and interactive game channels and about 30 pay per view video channels.

The broadcasts include a basic package which each subscriber is required to purchase as well as additional channels chosen by the subscriber, whether as a package or whether as a single channel, based on plans defined from time to time by DBS, with the approval of the Council and pursuant to the terms of the broadcasting license.

The main channel packages marketed by DBS in addition to the basic package are the movie package, the entertainment package, the children's package, the music package and the sport and enrichment package. These channel packages appeal to different target populations depending on their viewing habits and preferences.

As part of its operations, DBS also allows its subscribers to purchase movies and programs on a pay-per-view basis, from a list of movies and programs which is updated from time to time.

DBS is acting to obtain approval to launch VOD services (See Section 5.6.5A below).

DBS sells its subscribers decoders, which are necessary in order to record its broadcasts. DBS also sells a decoder known as a PVR (Personal Video Recorder) under the brand name YesMax, which, in addition to receiving broadcasts, has the ability to record and suspend picture using a hard disk and which has excellent sound quality.

5.3 Revenues and Profitability of Products and Services

Following is a table containing a breakdown of DBS' revenues (in NIS millions):

	2005	2004	2003
Revenues	1,222	1,028	842
Operating profit	132	15	(170)

5.4 New Products

DBS is currently in the final stages of developing supply of VOD services via DSL to its subscribers. However, launch of the service requires receipt of the appropriate regulatory approvals, which have not yet been obtained.

5.5 Marketing and Distribution

DBS services are marketed by means of advertisements in various media outlets as well as by means of four principal distribution channels:

5.5.1 Sales people in the field working to recruit subscribers.

5.5.2 Telephone service center receiving telephone enquiries from customers wishing to receive DBS services.

5.5.3 Points of sale in shopping malls and commercial centers throughout the country.

5.5.4 External resellers of the company's services working on the basis of agreements with the company.

The distribution channels, except for the external resellers, are operated by DBS employees.

5.6 Competition

5.6.1 <u>Competitors in the broadcasting market</u>

DBS's main direct competition comes, as stated above, from the three principal cable companies: Arutzei Zahav and Co., Matav Cable Communication Systems Ltd., and Tevel Israel International Communications Ltd.

DBS estimates its share of the multi-channel television market as at December 31, 2005, to the best of its knowledge, at around 36% of total subscribers.

5.6.2 <u>Broadcasting characteristics of the competitors</u>

The Cable Companies have been operating in the broadcasting market since the beginning of the 1990s, in the past under regional franchises under conditions of exclusivity, and at present under long-term broadcasting licenses which replaced the franchises during the course of 2002. At present, the Cable Companies operate as a single entity, as set out in Section 5.1.1 above. In November 1999, the Cable Companies were declared to be a monopoly in the field of broadcasts in the areas of the franchises under which they operated at the time, under the Antitrust Law, 5748-1988.

DBS transmits its broadcasts using only a digital method, by means of tiering at various price levels, while the Cable Companies transmit their broadcasts to most of their subscribers using a digital broadcasting method and the above-mentioned tiering, while for the remainder they use an analog broadcasting method, which does not allow viewing electronic broadcasts or tiering and supply of 'personal television' but rather, of one identical channel package (for further implications of this difference, see Section 5.6.4B below).

5.6.3 Characteristics of the current competition

After DBS achieved high rates of growth in subscribers during the first years of its operations, inter alia due to temporary regulatory concessions given to it and a considerable technological gap, together with high churn rates amongst subscribers of the Cable Companies, in 2005, there was a relatively slow increment in the number of DBS subscribers (in 2005, the number of subscribers increased by approximately 50,000).

	2005	2004	2003
Increase in number of subscribers	49,823	55,795	44,537
Rate of growth	10.7%	13.5%	9.4%

At present, the competition in the broadcasting sector is focused on content, on the channel packages offered by the broadcasting companies, on prices of channels, on packages and on service.

(Including VOD services provided by the Cable Companies). Competition is also characterized by offers of other communications services as part of the service package (see Section 5.6.5B below). DBS invests efforts and resources both in marketing its services to the subscribers of its rivals as well as in purchasing special, quality content which it includes in its basket of services and broadcasts.

5.6.4 Positive and negative factors regarding the competition

In the estimation of DBS management, DBS has competitive edges, the principal ones being:

A. DBS has a significant advantage in terms of the technical quality of satellite broadcasts, which stems from broadcasting using advanced digital technology, which contributes to the quality of the picture and also enables translation into foreign languages, at the subscriber's election. In addition, the subscriber's user interface during viewing is quick, fast and convenient compared with that of the Cable Companies. DBS recently began wide-screen broadcasts on a variety of channels, and Dolby digital broadcasts on a number pay per view channels. These broadcast methods enable subscribers to view broadcasts on wide-screen views.

B. Another positive competitive factor stems from the fact that DBS's broadcasts are transmitted by satellite, and therefore, reception of the broadcasts is also possible in areas that are remote where there is no access to cable infrastructure.

However, DBS' competitive operations suffer from inferiority in a number of areas, the main ones being:

A. Inferiority of infrastructure in terms of launching of services that require high-speed bi-directional infrastructure, in particular VOD services (See Section 5.6.5A below).

B. Some of the customers of the Cable Companies' are customers of the cable analog systems (see Section 5.6.2 above). Insofar as such customers wish to switch to the digital system, the Cable Companies have much greater access to them since the analog broadcasting system allows its subscribers to receive lower-cost broadcasts without using a digital decoder.

C. Since the Cable Companies were for a long time the first and only players in the market, a number of homes of potential DBS subscribers have internal wiring installed by the Cable Companies which DBS usually has no alternative but to use. The directives issued by the administration of the Ministry of Communications, relating to the transfer of subscribers and use of the infrastructure installed in the homes of subscribers, require 36 hours' notice before disconnection of an existing subscriber of the Cable Companies (and vice versa in the case of disconnection of an existing DBS subscriber). The Cable Companies can exploit this time frame to make special offers to existing subscribers about to leave them for DBS, in order to retain their custom. In addition, where the internal wiring infrastructure is owned by the Cable Companies, the management directives stipulate that payment must be made thereof (and vice versa). For the hearing being held by the Ministry of Communications with respect to cable wiring, see Section 5.14.3 below.

D. The Company's license imposes restrictions on the structural separation between the Company and its subsidiaries and certain affiliated companies, among them DBS. The longer these restrictions remain in force, and at the same time no similar restrictions are imposed on the Cable Companies (and telephony and internet corporations affiliated to them), the more they will harm the DBS's ability to compete (for further details regarding these restrictions, see Section 2.16.2B above).

5.6.5 Principal methods for coping with competition

A. VOD

DBS views the provision of VOD services and similar services, such as interactive games, internet games and applications integrating pictures and other similar services to be an integral part of the services of those operating in the field of broadcasting in the modern era, and as a significant component, as part of the total package of services offered to subscribers.

However, whilst DBS's competitors commenced providing VOD services to their subscribers at the beginning of 2005, as at the date of this report, DBS has not yet received the consent of the Ministry of Communications to provide such to its subscribers, as set out below.

The satellite broadcasting system, despite its technical qualities, suffers from an in-built inferiority with respect to infrastructure, compared with the fixed-line infrastructure of the cable companies. This inferiority stems from the fact that high-speed satellite broadcasting is unidirectional only (from the satellite to the subscriber's home) whilst the return track (from the subscriber's home to the broadcast center) is not a high-speed satellite track, but is via an ordinary (slow) telephone line which does not enable the transmission of communications necessary for providing VOD services, and due to the fact that the satellite line includes a uniform, collective broadcast, to all subscribers, and does not enable individual broadcasting in accordance with the individual demands of each and every subscriber, certainly not in the amount and at the availability required in order to launch personal television services, mainly VOD services, as is usual around the world, and recently, in Israel as well, via the Cable Companies.

Due to the inferiority of infrastructure as referred to above, DBS applied to make use of the fast bi-directional line owned by the Company – DSL (Digital Subscriber Line) and to provide its subscribers with VOD based on that infrastructure, since a technological experiment done on that infrastructure was successful in 2004. This use of DSL infrastructure requires the consent of the Ministry of Communications, which requested to examine the need to amend the Law regarding the scope of services that a satellite broadcast licensee may supply (and the prohibition imposed upon it to provide 'cable services'), as well as the policy regarding providing such consent.

Following applications by DBS to the Ministry of Communications to approve supply of the services to its subscribers on a commercial scale, on October 11, 2005, DBS received the response to the general counsel for the Ministry of Communications stating, *inter alia*, that receipt of a commercial license to provide such services would require statutory amendments and that the Ministry of Communications has not yet formulated its policy regarding the application. Therefore, as the response states, DBS's application for a commercial license for the provision of the aforesaid services, and a license to perform experimental marketing, is not possible at this stage. Pursuant to that position, on October 27, 2005, the Senior VP Economics and Budgets at the Ministry of Communications wrote to DBS and to a number of other entities in the communications sphere, including the Company, the Cable Companies and internet access licensees, asking for their responses to the issue, including issues relating to network capacity, the ability to use the network, and pricing of the service (hereinafter: the "Hearing").

On December 25, 2005, DBS provided its response to the Hearing, setting out, *inter alia*, the importance and urgency of providing the consent to commercial supply of VOD services to DBS subscribers, the policy considerations that supply provision of such consent and the importance of the VOD service as an integral part of the modern broadcasting world.

To the best of DBS's knowledge, a number of entities in the communications field, including the Cable Companies, expressed their objection to the Ministry of Communications granting consent to DBS to provide its subscribers with VOD services, in the Hearing. As at the date of this report, the decision of the Ministry of Communications with respect to the Hearing has been delivered to DBS. Based on the position taken by the Ministry of Communications and expressed above, even if it is decided, as a matter of policy, to approve the application, it will only be possible to launch VOD services after amendment of the Law in this regard, except in the context of limited technological trials which DBS has asked to hold, and in DBS' estimation, this will be permitted.

In DBS's opinion, approval of its application to launch VOD services using DSL infrastructure will provide a response to the competitive need for launching such services. On the other hand, in DBS' estimation, failure to obtain permission to grant VOD services will cause severe harm to DBS' ability to compete with the Cable Companies.

B. Total service package

As set out in Section 5.1.8 above, during the course of 2005, demand from consumers and potential consumers to receive a "total service package" containing multi-channel television broadcasts and internet connection infrastructure services (at high speeds), and, in the future, fixed-line telephony services, developed as part of general developments in the field of communications. As a result, DBS currently sells a service package, together with the Company, which includes broadcasts and infrastructure to connect to high-speed internet services. However, due to regulatory limitations in the Company's license regarding structural separation between the Company and its subsidiaries and certain affiliated companies, including DBS, and in particular with respect to the supply of fixed-line telephony services, contrary to the Cable Companies which sell their subscribers a "triple" service package (see Section 5.1.8 above), under which they can reduce the prices of fixed-line telephony, the Company is unable to reduce the prices of fixed-line telephony under such a package.

5.7 Fixed Assets and Facilities

DBS broadcasts to its subscribers via an engineering setup which contains a ground broadcasting center located in Kfar Saba broadcasting to the satellite the content received at the center via optical fibers, cassettes and direct reception from the satellites, a secondary broadcasting site situated close to the Re'em Junction, leased space segments on the Amos 1 and Amos 2 satellites and receiver dishes and decoders located in subscriber homes, enabling receipt of the satellite broadcasts and decoding in accordance with the broadcasting package purchased by the subscriber.

5.7.1 Rental of structures

The DBS management and its broadcasting center, including all the technical and technological equipment contained in the broadcasting center, are located in two structures in the eastern industrial area of Kfar Saba in a total area of some 6,800 sq. m., alongside which are parking spaces and ancillary installations which have been leased by DBS in accordance with a memorandum signed with Azorim Shoar Ltd. (hereinafter: "Azorim") in May 1999. DBS leases these structures (which are fully occupied) for a lease period which ends in 2009, and it has the option of extending the lease period for another 10 years under the same conditions. DBS has the right of first refusal to purchase the premises from Azorim whenever they are put on sale.

In addition, DBS leases offices in various areas throughout the country, as follows:

Location of asset	Area in sq.m. (approximate)	Date of termination of lease
Haifa	1,288	05/2008
Beit Barkan	1,994	840 sq.m. 07/2006 1154 sq.m. 07/2008
Kanot	1,100	08/2007

5.7.2 DBS also uses a third-party site at the Re'em Junction which provides it with services allowing for the operation of the secondary broadcasting site, in which DBS' broadcasting and backup equipment are located..

5.7.3 Terminal equipment

DBS installs a receiver dish and other terminal equipment in subscriber homes, among them, decoders used as a receiving and decoding unit for the reception signals, which constitute an infrastructure to the subscriber's television screen as well as smart cards used to decode the encrypted broadcasts, which are transmitted via the encryption system of NDS company (see Section 5.15.3 below).

Some decoders are leased to subscribers in return for a fixed leasing fee paid during the broadcast reception period and some are lent to subscribers (some of these loans are made in return for a deposit which is reduced over the subscription period). A small number of the decoders are sold to subscribers and owned by them.

5.8 Intangible Assets

5.8.1 Licenses

DBS owns the following licenses:

5.8.1.1 Broadcasting license valid until January 2014 - this license is material to DBS's operations and constitutes the regulatory permit for its broadcasting operations (for the conditions of this license, see Section 5.14 below).

5.8.1.2 License for satellite television broadcasts in the Judah and Samaria region valid until January 2009, and by virtue of this license whose provisions are similar to those of DBS's main broadcasting license, DBS broadcasts to the Judah and Samaria region.

5.8.1.3 License to perform uplink operations (transfer of broadcasts from DBS's broadcasting center to the broadcasting satellite and implementation of set and ancillary operation activities), which is valid until January 2014 or until the end of DBS's broadcast license, whichever is the earlier. This license is material to DBS's operations and constitutes the regulatory permit for the transmission of broadcasting messages from the broadcasting center to the broadcasting satellites and from them to subscriber homes.

5.8.1.4 License for the provision of uplink/downlink services to other communication licensees which is valid until July 2008. As at the date of publication of this report, DBS does not use this license.

5.8.2 Intellectual property assets

A. Trademarks

DBS owns a variety of trademarks designed to protect its various brands and services and also a number of trademarks which are in the process of being registered on the Register of Trademarks. The main trademarks relate to the protection of its trading name (Yes), its key content channel names, the channel packages it markets and its unique terminal equipment which it installs in subscriber homes.

B. Copyright organizations

DBS owns the copyright to the various television content it produces as well as the copyright usage licenses owned by third parties for the purpose of broadcasting and integration into the framework of its subscriber broadcasts. For these usage rights DBS pays the content copyright holders via the six official organizations in Israel, which collect the royalties owed to the owners of the intellectual rights pursuant to the general licenses (known as "blanket licenses") granted to DBS. These payments are mostly based on a fixed payment, irrespective of the number of subscribers viewing the content (or listening to recordings, as the case may be), the rights to which have been purchased and sometimes on various pricing methods, including some which are dependent on the number of subscribers as aforesaid.

For some of the content that DBS purchases, it is also required to pay for the actual broadcast of the content.

DBS's costs to such collection organizations in 2005 amounted to approximately NIS 11 million.

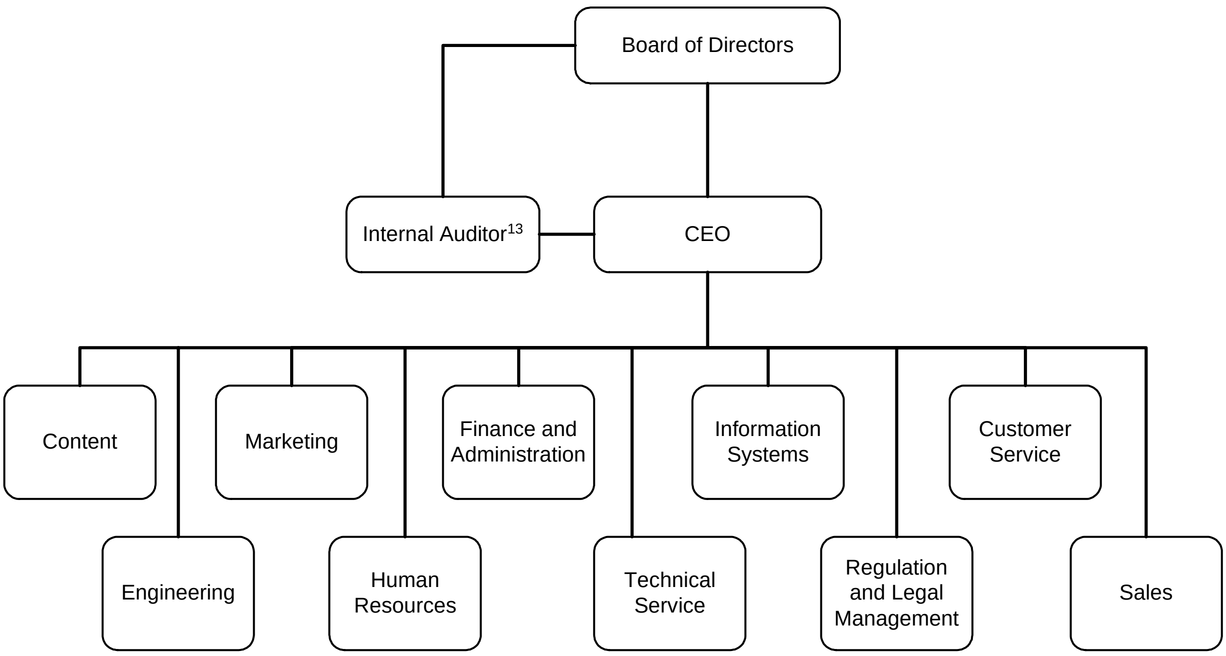
C. Investment in content

DBS purchased broadcasting rights for 2005 from various owners of copyrights to intellectual property for purchased content. DBS's usage rights to said content are very important to its operations since most of its broadcasts use third-party content and also combine purchased content with content used by DBS for the purpose of producing programs and trailers. DBS from time to time grants usage rights to television content it produces or purchases for franchisees from the Second Television and Radio Authority for re-broadcasting of said content. The total costs of the broadcasting rights to said content for 2005 amounted to some NIS 408 million.

5.9 Human Capital

5.9.1 Organizational Structure

DBS consists of 8 divisions, each of which is headed by a vice president who serves as a member of DBS's management. The divisions include marketing and sales, customer service, content, engineering, finance and operation, human resources, regulation and legal management and information systems, as depicted in the following chart



[13] The auditor is an external auditor.

5.9.2 Headcount of DBS personnel by division

Division	Number of employees	
	As at December 31, 2004	As at December 31, 2005
Sales and Marketing	414	364
Customer service	1,143	1,051
Content	38	49
Engineering	63	68
Finance and Operation	91	109
Human Resources	10	13
Regulation and Legal Management	2	2
Information Systems*	6	24
Management	4	4
Total	1,771	1,684

5.9.3 Training and development of human capital

DBS provides regular training for its customer service, technical service and sales personnel.

In 2005 DBS consolidated its training and instruction center consolidating the three main training tracks, which is used as a training center for all DBS managers and employees.

DBS trains some 1,000 employees every year.

5.9.4 Organizational change

In 2005, DBS consolidated its customer service and technical service divisions into one division, called the Customers Division, and also consolidated the marketing and sales divisions into a single division.

5.9.5 Employee remuneration schemes

DBS has goal-oriented remuneration schemes for its senior management.

5.10 Raw Materials and Suppliers

5.10.1 Main raw materials

The main raw materials used by DBS for its broadcasting operations are:

A. Television content

Television content, broadcasting and broadcasting channel rights purchased by DBS for its broadcasts. The broadcasting rights include movies, series and other original programs from local and foreign producers, mainly from the USA (see Sections 5.8.3 and 5.8.4 above).

The broadcasting rights purchased by DBS are presented in DBS's books on the basis of their cost, where the broadcasting usage rights relating to the screening of movies and television programs includes payments made to rights providers pursuant to the agreements with them.

The broadcasting rights are amortized in accordance with their purchase agreements, on the basis of the actual content screening (where the part which is not amortized by the end of the agreement period is amortized in full on the basis of the agreement period) or in equal parts on the basis of the rights agreement period.

The costs of the independent productions of programs which DBS believes may be broadcasted a number of times or may be sold to a third party are considered part of the broadcasting rights inventory of DBS, and their cost is amortized over their estimated usage period or in accordance with the estimated number of future broadcasts of such programs.

In view of the proliferation of content providers from which DBS purchases broadcasting rights, DBS does not have a main provider and is not materially dependent on one single content provider. However, in the Israeli sport broadcasting sector there is dependence, as at the date of this report, on the purchase of broadcasting rights for the channels known as “Channel 5” and “Channel 5+” from the provider of these contents (JCS). There is also dependence on the other supplier of sport content, Charlton Ltd.

B. Space segments

DBS leases rights to satellite space segments via which DBS broadcasts from the satellites to the reception dishes installed in subscriber homes. The space segments are leased by means of long-term agreements with two owners of the rights to the space segments (see Section 5.15.2 below).

DBS is dependent on the continuing regular availability of the space segments (see Section 5.19(E) below).

C. Digital decoders

DBS purchases digital decoders in order to receive and decode encrypted broadcasts in the homes of its customers. DBS is dependent on the provider from which it purchases the decoders. Replacement of this provider with another provider does not entail material extra cost, but the replacement would require a significant preparation period to adapt the decoders of the replacement provider to DBS’ broadcasting and encryption system. For a description of the agreement with this provider see Section 5.15.1 below.

D. Operating and encryption systems

DBS purchases from NDS services linked to the operating systems of its broadcasting setup and encryption means (see Section 5.15.3 below) as well as hardware for these services. DBS is dependent on the continuing supply of these services.

5.11 Working Capital

5.11.1 Customers

DBS collects subscriber fees from its customers at the end of each calendar month for the previous completed calendar month. As at December 31, 2005, customer credit amounted to approximately NIS 138,977 net.

5.11.2 Supplier credit

The average supplier credit period in 2005 was 134 days.

5.11.3 Deficit in working capital

As at December 31, 2005, DBS’s deficit in working capital amounted to NIS 458,812 thousand.

In 2004 and 2005, DBS reduced its working capital deficit.

5.12 Financing

5.12.1 Average interest rate for loans

5.12.1.1 Shareholders

The loans granted to DBS by its shareholders (among them the Company) are divided into three types:

5.12.1.1.1 CPI-linked non -interest bearing loans.

5.12.1.1.2 CPI-linked loans bearing annual interest of 5.5%.

5.12.1.1.3 CPI-linked loans bearing annual interest of 11%.

5.12.1.2 Institutional bodies

Loans provided to DBS by institutional bodies in 2005 are linked to the consumer price index and bear interest at an annual rate of 11%.

5.12.1.3 Banks

Short-term interest – the average interest rate for this credit for 2005 is 6.5%.

Long-term credit – there are two types of loans:

A. Loans based on prime interest rates, the average daily interest rate for 2005 being 6.5%.

B. Loans linked to the consumer price index, the average interest rate being 6.8%.

5.12.2 Credit restrictions applicable to corporations

Pursuant to the finance agreement of May 2001, as amended from time to time, between DBS and a bank consortium which arranged bank finance for DBS (hereinafter: the "Finance Agreement"), DBS must comply with all the following financial criteria:

A. Minimum overall income.

B. Minimum operating surplus.

C. Minimum operating surplus less DBS investment in decoders and modems.

D. Maximum supplier credit.

E. Minimum targets for coverage of the bank debt and debt balances.

F. Maximum overall finance requirements.

G. Maximum churn rate.

The values for meeting the financial criteria are variable and are measured quarterly. Non-compliance grants the banks the right to demand early repayment of the loans and the right not to award DBS any further unused credit line. During the course of 2005, the banks completed providing the full credit facility to which DBS was entitled under the finance agreement (apart from a sum of approximately NIS 500,000), in return for provision of the shareholders loans by DBS' shareholders, at the rates required under the finance agreement (with the exception of shareholders' equity the provision of which the banks waived under an amendment to the finance agreement of December 2005) (in this Section: the "Amendment"). During the course of 2006, DBS is expected to commence gradual repayment of the bank credit that it has taken, until full repayment in 2013. As at December 31, 2005, DBS is in compliance with all of the financial criteria set out in the finance agreement (following a concession granted to DBS under the Amendment relating to the maximum supplier credit criterion).

In view of the forecasts of DBS management regarding its business results for 2006, DBS will be required to act to obtain the banks' approval to update the financial criteria in the finance agreement.

DBS is also in negotiations with the banks to resolve a dispute relating to insurance obligations set out in the finance agreement.

In addition to the above-mentioned financial commitments, pursuant to the Finance Agreement additional restrictions anchored therein apply to DBS, the main ones being:

A. Restrictions on its compliance with its business plan and the update of this plan.

B. Restrictions on the assumption of third-party liabilities, including the receiving and granting of credit.

C. Restrictions on the distribution of profits and payment of management fees to the shareholders.

D. Restrictions on the creation of pledges and sale of certain assets without consent from the banks.

E. Restrictions on DBS's transactions with interested parties, changes of ownership in DBS, the purchase of securities in any corporation and the offering of its securities to the public (including the issue of debentures).

F. Restrictions on the shareholders' loans granted to DBS by the Company, among them their subordination in relation to the bank credit (and debentures issued to the public, if any), and restrictions on their repayment before repayment of the bank credit in full, or with respect to certain shareholders' loans before repayment of part of the bank credit, on the conditions set out in the finance agreement.

DBS is committed to repaying, by way of mandatory repayment, sums received with respect to the issue of shares or debentures to the public, from the sale or transfer of property and certain of DBS' cash flow surpluses, on such conditions and at such rates as are set out in the finance agreement. DBS is entitled to repay sums received with respect to the issue of shares or debentures to the public by way of early repayment, voluntarily, which might remain after effecting the abovementioned mandatory repayment, on such conditions and at such rates as may be set out in the finance agreement.

The finance agreement further sets out provisions regarding various reports that DBS must provide to the banks, including with respect to assessing its compliance with financial conditions.

The finance agreement sets out a list of events that constitute breach of it, and that entitle the banks, under conditions set out in the finance agreement, to make the bank credit immediately repayable.

DBS encumbered its assets and goodwill with a floating charge in favor of the banks and placed fixed charges over its rights in accordance with material agreements to which it is a party and the insurance rights to which it is entitled under the insurance policies issued to it.

DBS shareholders, with the exception of the Company, charged the DBS securities in their possession in favor of the banks, to secure the amounts which the banks made available and will make available to DBS. Most of the shareholders also charged their rights to repayment of the shareholders' loans granted to DBS in favor of the banks and confirmed to the banks that these loans would be inferior to the bank credit. In view of the restrictions on the Company's ability to charge its assets as a result of the negative pledge created by the Company in favor of its creditors (see Notes 13 and 14 to the Company's financial statements for the year ended December 31, 2005, which are included in this Periodic Report), on November 23, 2000 the Company gave a guarantee of DBS's debts to the banks, provided that the amount which the banks receive in repayment by the Company of its guarantee does not exceed the value of its shares in DBS on the date on which the banks realize the shares which the other shareholders charged in their favor. The Company also gave an undertaking to sell its shares if the shares charged by the banks are sold. Pursuant to a deed of amendment of the guarantee of May 2, 2002, the Company consented that in the event of realization of the collateral given by the other shareholders the Company would waive repayment of the shareholders' loans it granted to DBS. The Company also consented that its guarantee would also apply, *mutatis mutandis*, to the options allotted to DBS and to the right to receive them.

The shareholders in DBS with the exception of Gilat DBS Ltd., gave an undertaking to the banks not to oppose the sale or other realization of their shares in DBS, which had been pledged or in respect of which a guarantee had been given (by the Company), so that the bank could make the sale without disturbance in the form of a friendly liquidation.

5.12.3 Credit amounts received in 2005

In 2005, DBS received shareholders' loans amounting to some NIS 82 million, loans from institutional entities in the sum of NIS 100 million. In addition, the banks increased their credit facility to DBS by approximately NIS 43 million. Increase of this facility included the sum of NIS 25 million provided to DBS in December 2005, as part fo the Amendment. Under the Amendment, the additional credit as aforesaid is intended to be repaid within three years, at the rates set out in the Amendment, however, in the event of injection of shareholders' equity into DBS by its shareholders prior to the dates of repayment of the credit as aforesaid, DBS is required to repay the sum of the injection early. As at the date of this periodic report, DBS and the banks are in negotiations towards signing a detailed amendment to the finance agreement which will fix the principles set out in the Amendment, as well as the arrangements that go along with it.

5.12.4 The Corporation's credit facility

DBS's credit facility is approximately NIS 1,465 million and it is used for the current operation and the granting of bank guarantees for DBS's operations. As at December 31, 2005 DBS had utilized NIS 1,421 million of this credit.

The credit taken by DBS from institutional entities (at a total rate of NIS 100 million) was received under loan agreements dated March 2005 and April 2005. This credit was taken on inferior repayment conditions compared with the bank credit, apart from exceptions that are similar to those which apply to the shareholders' loans provided by shareholders of DBS after April 1, 2004. In assurance of repayment of the loans to institutional entities, an undertaking was given by the Company (which is conditional, *inter alia*, upon DBS having a positive worth), as set out in Note 8E to the financial statements of the Company for the year ending December 31, 2005, which are included in this periodic report, and the banks that are financing DBS's operations agreed that in the event of exercise of the Company's shares in DBS by them, the financial entities shall be entitled to a proportionate part of the receipts of such, at the rate set out in the agreements. The institutional entities were also given an option to provide loans in an identical sum to that provided by them provided that the sums of the loans are required under DBS's business plan, and this option is exercised by them in full. Concurrent with these agreements, appropriate amendments were made to the finance agreement with the banks financing DBS's operations, the main point of which was to view the loans received from the institutional entities as shareholders' loans as aforesaid.

5.12.5 Need for raising of additional sources of capital

DBS's management is acting to obtain additional sources of finance in order to enable it to realize its plans for the coming year. If such sources are not obtained, DBS shall operate in accordance with an alternative business plan, based on the sources of finance available to it at present.

For details of the shareholders loans and for the position taken by the Ministry of Communications regarding limitations on the provision of shareholders loans by the Company, see Section 5.19B below and Note 8E to the Company's financial statements for the year ended December 31, 2005, included in this periodic report.

5.13 Taxation

See Note 11 to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

Following an audit of assessments for the years 2000-2003, DBS was issued assessments by the income tax commission in accordance with its best judgment. DBS has submitted an objection to the aforesaid assessments, but a date for hearing such objection has not yet been set down.

5.14 Restrictions on and Supervision of the Corporation

5.14.1 Specific legal restrictions on operations

DBS's operations are regulated by and subject to a special extensive system of laws (from primary legislation to administrative directives and Council decisions). The abovementioned legislation, secondary legislation, Council decisions and administrative directives have a material effect on DBS and its operations. Primary and secondary legislation also have a material effect on DBS in the communications arena in general.

Restrictions are applicable to DBS by virtue of the Communications Law and the regulations promulgated pursuant thereto. The Telecommunications (Proceedings and Conditions for Grant of Satellite Broadcasting License) Regulations, 5758-1998 (hereinafter: the "License Regulations"), determine the processes and conditions for receipt of a broadcasting license, and also various restrictions applicable to a licensee during the term of the license. The License Regulations prescribe, *inter alia*, suitability conditions for a satellite broadcasting licensee, relating to the direct or indirect holdings of the broadcasting licensee and the interested parties therein, in cable broadcasting franchisees, in franchisees pursuant to the Second Authority for Television and Radio Law, 5750-1990, and in proprietors of daily newspapers.

The Telecommunications (Television Broadcasts via Satellite) (License Fees and Royalties) Regulations, 5759-1999 determine the percentage of royalties and broadcasting license fees to be paid by the satellite broadcasting licensee to the state. Under these regulations, DBS is required to pay royalties at 3.5% of its revenues from the provision of broadcasting services in 2004 and thereafter. DBS applied to the Ministry of Communications and the Ministry of Finance seeking to cancel the obligation to pay the royalties, or at the least, to reduce the rate of them in accordance with the reduced rates recently prescribed for MRT licensees, international licensees and domestic fixed-line licensees. To the best of DBS's knowledge, a decision has not yet been handed down in respect of this application.

Under Section 6WW of the Communications Law, the license may prescribe the maximum prices that a subscriber may be billed. As at the date of this report, no such prices have been prescribed.

In accordance with the requirements of the broadcasting license and regulations determined by the Council, in 2004 and 2005 DBS shall invest in local productions an amount which is not less than 8% of its revenues from subscriber fees. According to a decision of the Council, in 2002 DBS was in compliance with its obligation to invest in local productions, except for approximately NIS 3,900,000 and under-investment of approximately NIS 7,800,000 in original quality productions, and in 2003, DBS had met the obligation to invest in local productions except for the sum of approximately NIS 370,000 and under-investment of approximately NIS 5,200,000 in original quality productions, however the Council allowed DBS to make up these shortfalls during 2004 and 2005 (with original quality productions). DBS notified the Council that it had met its local production obligations for 2004 (including the proportional part of completing past obligations), and the matter is currently being examined by the Council. According to a decision of the Council dated September 2005, the rate of investment of DBS's revenues in local productions during the years 2006 and 2007 will stand at 8% of such revenues.

In accordance with the requirements of the law and the license, DBS is obligated to allow independent channel producers pursuant to Section 6(55) of the Communications Law to use its infrastructures in order to transmit broadcasts to its subscribers, in return for a payment which will be determined in the agreement, and in the absence of an agreement, in return for a payment which the Minister will determine after consultation with the Council.

5.14.2 Operations subject to broadcasting license

DBS's operations are subject to the provisions of its broadcasting license. The Communications Law, the License Regulations and the license stipulate a number of grounds on the basis of which the Minister of Communications can terminate, restrict or make the broadcasting license conditional, after consultation with the Council and the granting of a hearing to the broadcasting licensee, among them, violation of the provisions of the law or rules and regulations pursuant thereto, a material violation of the terms of the broadcasting license or a non-material violation which was not amended after a warning from the Minister or the Council, the cessation of broadcasts for an unreasonable period of time or the total cessation of broadcasts for 14 consecutive days, noncompliance of the licensee with the restrictions determined in relation thereto in the License Regulations, and the appointment of a receiver or temporary liquidator for the licensee or the issuing of a liquidation order, all pertaining to the licensee.

The Minister of Communications, in consultation with the Council, and after granting the broadcasting licensee an opportunity to make its arguments and considering the harm to its rights, may change the terms of the broadcasting license, *inter alia*, for the purpose of the goals stipulated in the license. In addition, the Council alone has concurrent authority to amend the broadcasting license, provided that the broadcast licensee is first of all given an opportunity to make claims.

5.14.3 Principal restrictions by virtue of the law and broadcasting license

The Communications Law and Broadcasting Regulations stipulated the following principal general conditions: the broadcasting license may not be transferred or attached; encumbrance of the broadcasting license, insofar as it may be encumbered under the law, requires prior written approval from the Minister of Communications; transfer, encumbrance or attachment of any of the assets of the broadcasting license from August 2001 onwards, which were not granted advance permission in the license, require approval from the Minister of Communications, except for encumbrance of an asset in favor of a banking corporation; an encumbrance placed on any of the broadcasting license's assets shall not be realized unless as determined by the Minister of Communications; DBS's broadcasts under the broadcasting license, and the scope thereof, are subject to the Law (for the statutory restriction on VOD services, see Section 5.6.5A above); a change, directly or indirectly, in control or holding of the means of control in a percentage of 10% or more or in any percentage resulting in a person becoming an interested party or controlling party in the licensee requires approval from the Minister of Communications, after consultation with the Council (this provision does not apply to a change which does not exceed 15% of the holding of the means of control in a company whose shares are listed on the Stock Exchange, provided that it is not a change in the control thereof, all in relation to said shares listed on the Stock Exchange); reporting requirements were stipulated concerning holders of the means of control and restriction on encumbrance of the means of control; cross-ownership in the licensee is prohibited as set forth in the License Regulations; competition pertaining to the provision of broadcasts and services shall not be prejudiced, including terminal equipment or other telecommunications services, by any agreement, arrangement or understanding to which the broadcasting licensee, any body in which the broadcasting licensee, an officer of the broadcasting licensee, or any owner of a right in a company owning a broadcasting license (and also an officer of the owner of a right therein) are parties thereto, unless approved in advance and in writing by the Council; advertising broadcasts are prohibited (this prohibition also applies to the Cable Companies) except for the transmission of foreign channels containing advertisements which are not aimed primarily at Israel and except for sponsorships and service broadcasts.

The broadcasting license also contains terms governing the establishment and operation of a satellite broadcasting system; terms governing subscriber services, among them the duty of the Council and the Uniform Contracts Tribunal to approve subscriber agreements, the duty to connect applicants and ban on stipulating conditions, the duty to maintain the service throughout the year, prohibition on discrimination between subscribers, except for the offering of various tariffs to subscriber types which are reasonably differentiated, the establishment of a subscriber service center; establishment of an ongoing setup for the supply and maintenance of terminal equipment and protection of subscriber privacy; terms concerning the provision or disconnection of service and terms linked with the oversight of the operations of the broadcasting licensee and the duty to submit reports to the Ministry of Communications; conditions regarding whether the terminal equipment installed by DBS complies with standards.

The broadcasting license stipulates provisions regarding the types of payments that the broadcasting licensee may collect from its subscribers. The broadcasting license also stipulates that the list of prices that the broadcasting licensee collects from its subscribers for broadcasts and services shall be first submitted to the Council for approval, and that any amendment thereto shall be first submitted to the chair of the Council for approval. The Council does not intervene in DBS' tariffs but ensures that there is no bias or discrimination between subscribers or breach of the provisions of the law. With respect to reductions, discounts and promotions (for a restricted period), DBS is required to notify the chair of the Council no later than the date of publication or commencement, whichever is the earlier, and the chair may intervene if he finds them to be misleading to the public or as drawing distinctions between subscribers.

The broadcasting license sets out a number of provisions that relate to the content of DBS's broadcasts, including approval of the channels broadcast by DBS and amendments in respect of them by the Council (including the content of the Company's basic package), approval of the electronic program guide (EPG) which is part of DBS's digital service to its subscribers.

DBS is also required to transmit the television and radio (FM) channels lawfully broadcast in Israel which can be received from the air, ground or satellite, the educational television channel and "must carry" broadcasts to its subscribers. Under the provisions of the Law, DBS currently transmits broadcasts of two "must carry" channels, the music channel ("Channel 24") and the Russian-language channel ("Israel Plus"), in return for a sum to be set by the Minister of Communications (as at the date of publication of this report a fixed payment had not yet been set for the transmission of the “must carry” channel), and also two independent licensees “Nature of Things Channel” and “Clicka” channel which collect subscriber fees directly from their customers.

Pursuant to a decision of the Council dated January 2006, DBS, including its shareholders, are entitled to own up to 30% of the local channels broadcast in DBS’s broadcasts (compared with a 20% restriction that applies to the Cable Companies).

In 2001, the Ministry of Communications issued administrative orders regulating the method of transferring subscribers from the services of the Cable Companies to DBS and vice versa, and use of the infrastructure installed in the subscriber’s home (the “administrative orders”). The administrative orders also provide an obligation to pay a monthly fee for infrastructure owned by the other multi-channel television provider.

Since entry into force of the administrative orders, the cable companies have made claims against DBS to the effect that it is in breach of the administrative orders. DBS, for its part, made claims of breach of the administrative orders by the cable companies, to both the Ministry of Communications and the cable companies.

On August 16, 2004, DBS received a letter from the Director General of the Ministry of Communications in which he gave notice to DBS that given the extent of its breaches of the administrative orders, he intended to issue a demand to DBS to pay sanctions for 15 breaches out of all of the breaches committed by it, in the total sum of NIS 1,354,500. DBS objected to the imposition of such sanctions, and to date, no such letter of demand has been received.

On August 15, 2005, the Ministry of Communications gave notice to DBS and the cable companies that in light of their many breaches of the administrative orders, it has examined the issue and is currently considering repealing them *inter alia* in light of the mechanism for purchasing wiring set out in the Communications Law, which enables a subscriber to purchase the wiring in his home for NIS 120. On November 2, 2005, DBS submitted its position to the Ministry of Communications to the effect that the administrative orders should remain in force, whilst repealing the prior notice obligations set out therein which require the giving of notice to the party whose subscribers are disconnecting from their service. DBS also claimed that the statutory provision affording title to the multi-channel television provider over the infrastructure installed by it in the subscriber’s home should also be repealed. DBS claimed that at least, if this provision is to remain, then the proper interpretation of it ought not be to give the cable companies title to the wiring installed by them in private homes. DBS also claimed that the sum set out in the Law as the consideration to be paid for purchase of the wiring (NIS 120) has no basis and that should the provision remain in force, it should be reduced considerably. DBS further claimed that the arrangement being considered by the Ministry of Communications is deficient and has many faults, and will prevent the proper transfer of subscribers under it, and will harm competition. As at the date of this report, the results of the hearing have not yet been reported.

5.15 Substantial Agreements

Following is a summary description of the principal agreements likely to be considered as material agreements not in the normal course of business of DBS which have been signed and/or are valid in the period of the Periodic Report:

5.15.1 Agreement for the purchase of decoders

In August 2000 DBS signed an agreement for the purchase of decoders with Advanced Digital Broadcast Ltd. (hereinafter: “ADB”) and Eurocom Marketing (1986) Ltd. (hereinafter: “Eurocom”), in which Eurocom Communications Ltd., an interested party in DBS, is also an interested party (hereinafter: the “ADB Agreement”). Under the ADB Agreement, DBS purchased a minimum number of decoders from ADB and is also entitled to purchase additional decoders from time to time in accordance with a purchase order which DBS is to send to Eurocom. DBS is also responsible for the converters and support service thereof via Eurocom. Repair to the decoders is carried out in accordance with an agreement with it from April 2001, which is automatically renewed unless terminated by one of the parties thereto, and which determines conditions and dates for the provision of maintenance services (and replacement of the decoders, if necessary) by Eurocom. In 2005, DBS purchased decoders from Eurocom in the sum total of NIS 92 million. DBS also decided to continue at this stage to purchase additional decoders under the ADB Agreement.

5.15.2 Space segment lease agreements

First space agreement

In order to transmit the satellite broadcasts DBS signed an agreement in April 1999 with the HLL Satellite Communications Company (Spacecom) Ltd. (hereinafter: "HLL"), in which there is an interested party which is also an interested party in DBS, and with Israel Aircraft Industries for the leasing of space segments in the Amos 1 satellite as amended in May 2003 (hereinafter: the "First Space Agreement"). The lease period determined in the First Space Agreement will conclude on June 30, 2009 (in relation to the period from January 1, 2009 – subject to the purchase by DBS of insurance cover as defined in the agreement) or upon the end of the life of the Amos I satellite, the earlier of the two, and if DBS continues to use the space segments after the end of the lease period, it shall continue to pay the leasing fees. DBS undertook to lease at least 8 space segments on the satellite and it was granted an option to lease up to two and a half more space segments (and in a particular case, half a segment more) and the right of first refusal to lease any space segment on the satellite's Middle East beam, which will be offered for leasing by HLL or Israel Aircraft Industries. As at the date of publication of this periodic report, DBS has not completed reducing its past debt, as required under the amendment to the agreement of May 2003.

The rental set out in the First Space Agreement consist of fixed annual rental for every space segment used by DBS.

The First Space Agreement regulated mechanisms guaranteeing reserve and backup in the event of satellite faults. *Inter alia*, it was prescribed that the satellite's reserve transponder used as backup for the satellite's entire capacity would serve as reserve capacity for DBS if the reserve transponder were used to restore any satellite capacity. HLL undertook to make available one space segment within six months and within a further three months another reserve space segment which would be used as reserve capacity for the satellite's entire capacity. In the event of a fault contemporaneous with another capacity DBS has priority for the restoration of the capacity that it has leased.

Second Space Agreement

In May 2000 DBS signed another agreement with HLL to lease space segments on the Amos 2 satellite, as amended in May 2003 (hereinafter: the "Second Space Agreement"), whereby DBS leases from HLL no fewer than 12 space segments on the two satellites (of which 8 on Amos 1), and during 2005 DBS started to lease two additional segments on the same polarity, so there will be no need to adjust DBS's receiver dishes. The Second Space Agreement stipulates that at the end of the First Space Agreement the leased capacity on Amos 1 will be transferred to Amos 2 or to another suitable subsequent satellite.

Pursuant to the Second Space Agreement, the lease period for the space segments on Amos 2 is for 12 years from the date on which the satellite is stationed in space (which took place during April 2004) or until the end of the satellite's life, the earlier of the two. The consideration for the lease determined in the Second Space Agreement consists of annual lease fees to be paid in monthly installments, the amount of which depends on the total number of segments leased on the Amos 2 satellite, DBS, its shareholders and lessors affiliated with it and/or with its shareholders, as defined in the Second Space Agreement. The Second Space Agreement brings together space segments which are to be used as reserve capacity for the leased capacity on Amos 2, and alternative capacity if the leased capacity becomes unusable, and awards DBS the right of first refusal to lease other space segments on Amos 2 under the terms specified in the agreement.

HLL has undertaken to act to extend the lease period for the space segments beyond the current lease period, and for this purpose to endeavor to station a subsequent satellite in a suitable position, with similar technical characteristics, so that it will not be necessary to make changes to the receiver systems of DBS subscribers, under the conditions determined in the agreement, until December 31, 2013, provided that an appropriate agreement for the continuation of the satellite's life is signed by the parties, as shall be determined in said agreement, pursuant to which DBS will lease at least 14 space segments in consideration of annual leasing fees under similar commercial conditions.

As at the date of this report, DBS leases 7 space segments on the Amos 1 satellite (out of the 8 segments under the First Space Agreement), due to a technical restriction which prevented leasing of the eighth segment for a very long period, which required DBS to implement alternative permanent solutions. DBS is in negotiations with Aviation Industries regarding the obligation to lease the eighth segment, and the cost thereof. As at the date of this report, DBS is also leasing 6 space segments on the Amos 2 satellite. The rental in 2005 for the First Space Agreement and the Second Space Agreement amounted to approximately NIS 100 million.

5.15.3 Information and encryption system development agreement

In October 2000, DBS signed an agreement with NDS Limited (hereinafter: "NDS") for the development, licensing, supply, training, assimilation and maintenance of software and equipment for encryption, broadcasting, compression operations and ancillary operations required for DBS's multi-channel, broadcasting system, including development of a smart card inserted into a special decoder drive, by means of which the subscriber's viewing options can be controlled. The smart card may be updated using a satellite broadcasting signal. NDS undertook to adapt its equipment and services to the decoders purchased by DBS in accordance with the provisions of the agreement. NDS also undertook to provide DBS with support services and provide a warranty for its products. Pursuant to the agreement DBS may order and pay for additional broadcasting equipment and software and also make modification to the existing ones under the conditions set forth in the agreement. The provisions of the agreement were applied in January 2006, *mutatis mutandis*, to the advanced (second generation) version of the smart card. DBS pays for NDS's services and products based in principle on the number of converters it uses and the number of its active subscribers. In March 2004, DBS signed an additional agreement with NDS whereby NDS provides DBS with services linked to the integration and assimilation of interactive applications into DBS subscriber services, the granting of usage licenses for these applications and the development of future interactive technological services.

5.15.4 Information systems outsourcing agreement

In March 2004, DBS signed an outsourcing agreement with Ness A. T. Ltd. (hereinafter: "Ness") whereby DBS transferred its information system management and project implementation services (hereinafter: the "Service") to Ness and Ness assumed overall responsibility for the supply to DBS of the Service in an outsourcing format. DBS also transferred to the ownership of Ness certain equipment for which the services are provided and which will be transferred to DBS upon expiry of the agreement. The agreement period (subject to early termination rights conditional upon payment) has been defined as eight years from April 1, 2004 (hereinafter: the "Original Agreement Period"), and at the end of the Original Agreement Period the agreement term will be extended automatically for an additional period of five years (hereinafter: the "Extension Period"), unless one party notifies the other party in writing, at least 12 months before the end of the Original Agreement Period of its desire not to extend the Original Agreement Period. During the Extension Period each party may notify the other party in writing, at least 12 months in advance, of its desire to terminate the agreement. During the course of 2005, the parties agreed to stop outsourcing certain of DBS' information systems, and to return them to DBS' management. As at the date of publication of this report, the parties are in negotiations to examine certain amendments to the agreement.

5.15.5 Finance agreement with the banks

For a summary of the main points of the agreement, see Section 5.12 above and Note 8E to the Company's financial statements for the year ended December 31, 2005, which are included in this periodic report.

5.15.6 Agreements with DBS shareholders – see Section 2.17.3

5.15.7 Agreements with institutional entities – see Section 5.12.4 above.

5.16 Joint Venture Agreements

5.16.1 DBS purchases annual internet access packages at high baud rates based on DSL infrastructure, and sells these packages to its subscribers together with its broadcasts and services to its subscribers (see Section 5.6.5B above).

5.16.2 DBS has a joint venture with Bezeq International Ltd., a subsidiary of the Company, for the supply of a basket of services including multi-channel television services (supplied by DBS), infrastructure connection to the internet and internet access services (supplied by Bezeq International Ltd.). The venture operates under the brand name "yes-Wow". As of 2005, the venture has been operating on the basis of customer retention only, and no marketing or sales efforts are being made via it.

Under the venture, each party bears its own expenses (i.e. Bezeq International Ltd. re all matters relating to internet access services and DBS regarding all matters relating to multi-channel television services).

5.17 Legal proceedings

5.17.1 On December 29, 2005, an application was filed in the District Court at Tel Aviv to approve a claim, filed originally against DBS in the Local Court at Kfar Saba, as a representative action under the Consumer Protection Law, 5741-1981, under which the following relief is sought: (a) the award of financial compensation to every subscriber with whom DBS contracted by telephone, without a written contract (the Applicant left prescription of the amount of the compensation to the discretion of the Court, whilst in his own personal claim, compensation in the sum of NIS 20,000 is sought); (b) financial compensation in the sum of the permits collected for each subscriber who in fact paid sums higher than those agreed upon by telephone with DBS's service representatives; and (c) a declaratory order to the effect that each subscriber who contracts with DBS by telephone will also receive the arrangement in writing within 21 days.

DBS intends to submit an application to strike the application for approval of the claim as a representative action out *in limine*. At this initial stage, DBS is unable to assess the chances of success of the claim.

5.17.2 On June 1, 2005, Matav Cable Communications Systems Ltd., Tevel Israel International Broadcasting Ltd., Arutzei Zahav & Co, and Hot Telecom Limited Partnership (in this Section jointly: "HOT") filed a claim in the District Court at Tel Aviv following the incident known as the "Trojan Horse Incident". Under these proceedings, the Court is requested to award the following main remedies against DBS: An order against DBS and any person acting on its behalf in the past or in the present, declaring that HOT is the holder of rights in all of the commercial secrets (including information that is censored or privileged under law), obtained by DBS and/or any person acting on its behalf using illegal means contrary to the law; an order against DBS and any person acting on its behalf (including the Civil Intelligence Investigation Company) instructing them not to make any use of commercial secrets of HOT obtained by illegal means contrary to the law; an order instructing DBS and any person acting on its behalf not to transfer or delivery commercial secrets or information regarding them to any person; and an order instructing the transfer of all of the commercial secrets to a person to be appointed by the Court to collect the material and transfer it to HOT. The statement of claim does not include an application for any financial remedy. HOT gave notice that it reserves the right to update and add to the statement of claim.

Contemporaneous with the claim, HOT filed an application for temporary relief regarding the appointment of a receiver and injunctions with respect to HOT's commercial secrets that are in the possession of DBS.

On June 30, 2005, DBS filed a statement of defense with the court, denying the claims made by HOT in the statement of claim.

On July 7, 2005, the court decided, with the consent of the parties, to give force of an order to DBS's notice (given as part of its response to the application) stating that no use would be made of documents or information transferred to DBS by Civil Intelligence. In doing so, the court in effect dismissed HOT's applications to appoint a receiver and to award a temporary injunction that would be broader than DBS's undertakings.

On July 12, 2005, HOT filed an application to split remedies, so as to enable it to file a monetary claim against DBS under a separate action. In its application, HOT stated that at this stage, it is not yet possible to assess the financial damage caused to it as a result of the "theft of commercial secrets" that it alleges, since it is as yet unaware of the extent of the documents and information that had been given to DBS by Civil Intelligence. On September 18, 2005, DBS filed its response, in which it applied for the application to be dismissed. No ruling has yet been handed down on this application.

A date for hearing of the claim has not yet been set. At this stage, taking into account the fact that no financial claim has been filed yet, the fact that no ruling has yet been made on the application to split remedies and the novelty and complexity of the legal questions arising under the claim, DBS's legal counsel are unable to assess the chances of the claim.

5.17.3 In January 2006, an arbitration ruling was handed down in mutual claims (which included financial remedies, declaratory remedies and mandamus orders) between DBS and Play TV Ltd. (hereinafter: "Play TV") with respect to broadcast on March 5, 2005 of a pornographic movie produced by Play TV (in this Section: the "Movie") on the Playboy channel broadcast by DBS.

The arbitration ruling states, *inter alia*, that Play TV breached the agreement between the Parties in broadcasting the Movie, and in its conduct after the dispute regarding it arose, however, such breach did not amount to fundamental breach and did not entitle DBS to rescind the agreement; that Play TV bear the full fine imposed upon DBS as a result of cancellation of the Movie; and that DBS pay Play TV for DBS' employees who had watched Play TV's channels at no charge as of June 2003, and that to the extent that DBS' information systems do not enable it to extract data regarding actual viewing, payment would be made as if the percentage of DBS employees who watched the channel was equal to the percentage of DBS' total subscriber population who watch the channel, as such was for each month.

Soon after award of the arbitrator's ruling, a dispute arose between the parties as to implementation of it, with respect to the question of payment for DBS's employees who viewed the channel, in insubstantial sums, and as a result, Play TV filed a request to the arbitrator on January 24, 2006 to clarify his ruling. As at the date of publication of this report, the parties are in negotiation for a financial settlement.

5.17.4 On September 27, 2004, Endemol Nederland B.V. and Endemol International B.V. (hereinafter jointly: "Endemol") filed a claim against DBS and Synergia Productions Ltd. (hereinafter: "Synergia") in the District Court at Tel Aviv. The statement of claim alleged that the television program "Project Y" broadcast by DBS and produced by Synergia was a copy of a format which Endemol claimed to have created. According to Endemol, Synergia and DBS had breached Endemol's copyright in the format, had been unjustly enriched at Endemol's expense, and had caused it immense damages. Consequently, Synergia and DBS were sued to pay Endemol the sum of NIS 8,222,156 (or alternatively, NIS 1,840,000 by way of compensation without proof of damage), and to provide Endemol with details of all of their revenue from broadcast of the Project Y program.

On December 15, 2004, DBS submitted its statement of defense, in which it applied to dismiss the claim *in limine* or alternatively, to dismiss it substantively, *inter alia* on the grounds that a "format" is not a work that is protected under Israeli law, and for that reason, "Project Y" does not constitute a copy of such alleged "format".

The parties are in advanced stages of proceedings, and pursuant to a ruling of the Court, the date for completion of such proceedings is the middle of April 2006.

DBS has included a provision on its books for exposure, as estimated by its legal counsel.

5.17.5 For other legal proceedings in which DBS is involved, see Notes 19 and 8Eto the Company's financial statements for the year ended December 31, 2005, included in this periodic report, and Section 1.1.5 above.

5.18 Business Strategies and Goals

DBS's goals for the coming year are to continue the trend of increased revenues by continuing the growth in the number of its subscribers and in average per-subscriber revenues.

In order to achieve said goals, DBS intends to invest significant efforts in marketing and sales and an appropriate marketing strategy adapted to continuing subscriber recruitment, by using its sales setup (see Section 5.5 above), to continue its effort to create differentiation and innovation in broadcasting content compared with the content of the Cable Companies (see Sections 5.1.3.1 – 5.4 above), and to expand its value added services, with an emphasis on providing VOD services to its subscribers (see Section 5.6.5A above). Additionally, in order to increase revenues from subscribers, the Company is operating to increase the scope of the contents sold to subscribers.

DBS's goals relating to growth in the number of its subscribers and average per-subscriber revenues are based on forecasts of DBS's management, on the current trend in the broadcasting market and on DBS's assumptions regarding competition in the broadcasting arena and the present prevailing regulation. However, it is possible that the forecasts of DBS' management will not be fulfilled in view of changes in demand in the broadcasting market, the intensification of competition in this sector and the regulatory restrictions which have been imposed or will be imposed on DBS or on its cooperation with the Company (see Sections 5.1.6 and 5.17 above and Section 5.19 below). Realization of DBS's goals regarding launch of VOD services and personal television depend, in addition to the above, on obtaining the statutory and regulatory consents required for such (see Section 5.6.5A above).

5.19 Discussion of Risk Factors

A. <u>Licensing and regulation system</u>

DBS's operations and broadcasts are subject to a licensing system, oversight and approvals from various regulatory bodies (see Section 5.14 above), and consequently DBS is likely to be influenced and restricted by considerations of the policy dictated by these entities and by changes in communications legislation; the content of DBS's broadcasts is subject to special legislative arrangements, to supervision by the Council and to the obtaining of consents from the Council and the Ministry of Communications. Failure by DBS to comply with the instructions and rules of regulatory entities might cause the Ministry of Communications to impose fines and to revoke licenses that DBS holds.

B. <u>Regulation of additional sources of funding for DBS</u>

The raising of sources of financing, under DBS's business plan for the coming year, is vital for its ability to meet its business plan and to enable it to repay the bank credit on time (failure to pay on time as aforesaid gives rise to grounds for making the bank credit repayable immediately, in accordance with and subject to the provisions and restrictions in the finance agreement (see Section 5.12.2 above)). For the regulatory restriction on raising funds from shareholders of DBS, see Note 8E to the Company's financial statements for the year ended December 31, 2005, included in this periodic report.

Failure to raise the funds might cause DBS to fail to comply with the financial criteria set out in the finance agreement, which constitutes grounds for making the bank credit immediately repayment in accordance with and subject to the provisions and limitations of the finance agreement (see Section 5.12.2 above).

C. <u>Ability to offer integrated services</u>

See clause 5.6.5B above.

D. <u>Foreign currency and linkage differential risks</u>

A material part of DBS's expenses and investments is linked to changes in the exchange rate of the US dollar. Consequently sharp changes in the exchange rate have a material effect on the DBS's business results.

In addition, the loans that DBS has taken from banks and institutional entities are, in part, linked to the consumer price index, and therefore, a sharp increase in inflation rates might have a substantial effect on DBS's business results.

E. **Broadcasting and satellite centers**

DBS broadcasts from two broadcasting centers in Kfar Saba and at the Re'em Junction (see Section 5.7 above). Damage to a broadcasting center is liable to make it extremely difficult to continue broadcasting, however, the duplication of the broadcasting centers significantly reduces the risk entailed by damage to one of them and improves the survival ability of the broadcasts. As at the date of this report DBS broadcasts from the two broadcasting centers simultaneously. Should one of the broadcasting centers be damaged, DBS will transfer most of its broadcasts through the other broadcasting center, however, as at the date of this report, in the event of harm to DBS's broadcasting center at Kfar Saba, it will not be possible to transfer the broadcasts of DBS's independent channels via the other broadcasting center.

DBS broadcasts through space segments on the Amos 1 and Amos 2 satellites stationed in identical points in space (see Section 5.10.1B above). The duplication of the satellites by means of which broadcasts are transmitted to subscribers enables a significant reduction of the risk entailed by damage to one of them, and improves the survival ability of the broadcast. If there is a failure in one of the satellites, it will be possible to transfer most of the channels broadcast by DBS via the space segments on the second satellite and even possibly via additional segments which will become available.

F. **Technical inferiority**

DBS's infrastructure suffers from technical inferiority compared with the infrastructure of its competitors, as explained in Section 5.6.4 above.

G. DBS' broadcasts are based on an encoding of the broadcasts that are transmitted via satellite and the decoding of them by way of a smart card installed in the decoder at the subscriber's home (see Section 5.15.3 above). Defects in the encoding system, or a breach of it, might cause harm to broadcasts and to revenues from such.

Risk Factor Summary Table

	Extent of effect of risk factor on DBS operations		
	Large effect	**Medium effect**	**Small effect**
Licensing and Regulation regime – industry risk	X		
Regulation of additional sources of financing – special risk	X		
Ability to offer integrated services – special risk	X		
Exposure to chances in exchange rates and index – macro risk			X
Broadcasting center and satellites – special risk		X	
Technical inferiority compared with competition – special risk	X		
Encoding system – sector risk		X	

Date

Bezeq – The Israel Telecommunication Corp. Ltd.

Names and titles of signatories:

Moshe Arkin, Chairman of the Board of Directors

Ya'akov Gelbard, CEO

Chapter B – Directors' Report on the State of the Company's Affairs

Chapter B of the Periodic Report
Directors' Report on the State of the Company's Affairs
for the year ended December 31, 2005

We respectfully present the Directors' Report on the state of affairs of "Bezeq" - The Israel Telecommunication Corp. Limited (hereinafter: "the Company") and the consolidated Group companies (the Company and the consolidated companies together are hereinafter referred to as "the Group") for the year ended December 31, 2005 (hereinafter: "the Directors' Report").

The Group operates in four areas which are reported as business segments in the Company's consolidated reports as set forth below:

1) Fixed-line domestic communications

2) Cellular

3) International communications and internet services

4) Multi-channel television

The Company has other areas of activity which are not material to the Group's operations, and these are included in the financial statements as at December 31, 2005 of the Company in the "Other" business segment, consisting mainly of Network End Point services, customer service center services and content services for the business segment.

Below is information detailing the financial statements which were fully consolidated for the first time during the reporting period and were not fully consolidated in the entire prior year.

1. Pelephone Communications Ltd. ("Pelephone") - Full consolidation since August 26, 2004 (until that date, 50% proportional consolidation)

2. D.B.S. Satellite Services (1998) Ltd. ("DBS") - Full consolidation since June 21, 2004

1. Financial Position

A. The Group's assets as at December 31, 2005, amounted to approximately NIS 20.67 billion, compared with NIS 20.17 billion on December 31, 2004. Of these, approximately NIS 9.94 billion (approximately 48%) are fixed assets compared with approximately NIS 10.74 billion (approximately 53%) on December 31, 2004.

In the fixed-line domestic communications segment there was a decrease in the net book value of fixed assets resulting from the difference between depreciation expenses and the investment made in the reporting period. In contrast, there was also an increase in cash balances and short-term investments compared with the prior year.

In the cellular segment there was an increase in cash and cash equivalents, short-term investments and trade receivables compared with the prior year. Conversely, there was a decrease in the inventory balance due to streamlining measures taken by Pelephone and a reduction in the deferred tax balances due to utilization of past losses for tax purposes and a decrease in the net book value of fixed assets.

In the international communications and internet services segment, there was an increase in total assets compared with the prior year, due to an increase in cash balances. In contrast, net investments in fixed assets decreased in this segment compared with the prior year.

In the multi-channel television segment, there was a rise in broadcasting rights and in the customer credit balance. The increase was for the most part offset by a decrease in net investments in fixed assets.

B. The Group's shareholders' equity as at December 31, 2005, amounted to approximately NIS 8.06 billion, comprising approximately 39% of the total balance sheet, compared with approximately NIS 7.47 billion on December 31, 2004, which comprised approximately 37% of the total balance sheet. The increase in shareholder' equity derives from the Group's net earnings in the reporting period.

C. Total Group debt to financial institutions and debenture holders as at December 31, 2005, amounted to approximately NIS 8.92 billion, compared with approximately NIS 8.32 billion on December 31, 2004. The increase is primarily attributable to an offering of debentures in the cellular and fixed-line domestic communications segments, which was offset by repayment of long-term loans.

D. Group balances in cash and short-term investments as at December 31, 2005, amounted to approximately NIS 4.56 billion, compared with approximately NIS 2.74 billion on December 31, 2004. The increase is primarily attributable to the cash flow from operating activities in the principal segments in which the Group operates, as well as from an offering of debentures and receipt of loans.

2. Results of Operations

A. Principal results

Net earnings for 2005 amounted to approximately NIS 591 million, compared with net earnings of approximately NIS 621 million in the prior year. The difference in the results is primarily attributable to differences in the period in which Pelephone and DBS were consolidated during the reporting period compared with the prior year, and from changes in the operating income of the Group companies, increase in financing expenses, as well as Other revenues (expenses) in the Company, as outlined below.

Below are details of the changes in the results of the segments compared to the prior year.

Segment	2005 NIS millions	2004 NIS millions
Fixed-line domestic communications	851	971
Cellular[(1)]	466	379
International communications and internet services	98	118
Multi-channel television [(2)]	(99)	(85)
Others	1	8

Net earnings per share for 2005 amounted to NIS 0.227 per NIS 1 par value, compared with earnings of NIS 0.238 per share in the prior year.

B. Revenues

Group revenues in 2005 amounted to approximately NIS 11.10 billion compared with earnings of approximately NIS 9.27 billion in the prior year. The increase of NIS 1.99 billion is attributable to first-time consolidation implemented in 2004. Eliminating the effects of the first-time consolidation, there was a decrease in the Group's revenues which derived from the fixed-line domestic communications segment.

Revenues from fixed-line domestic communications decreased from approximately NIS 4.96 billion in 2004 to approximately NIS 4.72 billion in 2005 (a decrease of approximately 4.8%). Most of the decrease in the segment's revenues is attributable to tariff reductions in June 2004 and June 2005, a decrease in call and internet dial-up traffic, a decrease in revenues from the sale of equipment to subscribers and a decrease in royalties received from Pelephone. The decrease in revenues was moderated by ongoing growth in the number of customers who subscribe to high-speed internet service (ADSL). The auditors drew attention to the ongoing opening of the communications industry to competition and tariff changes.

Revenues from the cellular telephone segment increased from approximately NIS 2.97 billion to approximately NIS 4.43 billion, mainly as a result of the effect of the first-time full consolidation implemented during 2004. Amendment of the cellular network interconnect regulations and the reduction of interconnect tariffs commencing March 1, 2005 eliminated almost completely the upward trend in the segment's revenues despite the increase in the number of customers. This

(1) First-time full consolidation
(2) First-time consolidation

decrease was offset by the rise in revenues from sales of terminal equipment and from terminal equipment services.

Revenues from the international communications and internet services segment increased from approximately NIS 816 million in 2004 to approximately NIS 817 million in 2005. The slight increase relative to 2004 is attributable to growth in the routing of international call traffic and in internet revenues, which is derived from an increase in the number of high-speed internet customers. The growth was offset by a decrease in revenues from outgoing calls due to the continued decrease in traffic and decline in outgoing call tariffs as a result of greater competition in the current year.

Revenues in the multi-channel television segment increased from approximately NIS 542 million in 2004 to approximately NIS 1,222 million in 2005, mainly due to the consolidation of DBS during the course of 2004. In addition, there has been an increase in revenues in this segment compared with the prior year as a result of an increase in the number of subscribers and an increase in the average revenue per subscriber (ARPU).

C. General and Operating Expenses

The Group's general and operating expenses in 2005 amounted to approximately NIS 7.19 billion, compared with approximately NIS 5.57 billion in the prior year. Approximately NIS 1.5 billion of this increase is attributable to first-time consolidation.

In the fixed-line domestic communications segment, expenses remained virtually unchanged. Most of the decrease is attributable to the decreased general expenses and materials and spare parts expenses which were primarily offset by a rise in salary expenses and vehicle maintenance.

In the cellular segment, general and operating expenses increased from approximately NIS 2,217 million to approximately NIS 3,337 million during the reporting period, due mainly to the first-time full consolidation. In addition, expenses in the segment increased compared with the prior year, mainly due to the increased cost of terminal equipment alongside the increase in revenues from terminal equipment and increased subscriber acquisition costs which derive from winning the tender of the Accountant General at the Ministry of Finance. The increase was offset by a decrease in marketing expenses.

In the international communications and internet services segment there was an increase in general and operating expenses from approximately NIS 573 million to approximately NIS 621 million during the reporting period, mainly due to the increase in expenses for foreign managers, deriving mainly from a significant increase in traffic routed from one foreign operator to another foreign operator along with an increase in revenues from this service and an increase in expenses related to internet customers.

In the multi-channel television segment, general and operating expenses increased from approximately NIS 473 million in the prior year to approximately NIS 994 million in the reporting period, mainly due to the consolidation of DBS during 2004. In addition, expenses increased in the segment, relative to the prior year, due to the increase in content and other operating expenses.

D. Depreciation

The Group's depreciation expenses increased from approximately NIS 2,092 million in 2004 to approximately NIS 2,331 million in the reporting period, as the result of the first-time consolidation in respect of which depreciation expenses increased by approximately NIS 321 million. Eliminating this increase, depreciation expenses decreased as a result of fully depreciated fixed assets and a decrease in investments in new assets in the fixed-line domestic communications segment and the international communications and internet services segment. This decrease is partially offset by an increase in depreciation expenses in the cellular segment.

E. Royalties to the Government of Israel

The Group's royalties expenses amounted to approximately NIS 257 million compared with approximately NIS 221 million in the prior year. The source of the increase is the first-time consolidation referred to above, which was partially offset by a decrease in royalties expenses in the fixed-line domestic communications segment.

F. Operating income

The Group's operating income in 2005 amounted to approximately NIS 1,317 million, compared with approximately NIS 1,392 million in the prior year, a decrease of approximately NIS 75 million. The decrease in operating income is attributable to the changes in the results of the revenues and expenses sections of the segments described above. These changes led to a reduction in the profitability of the Group's main segments of operation, except for the improvement in the results of operations in the multi-channel television segment. The first-time consolidation of Pelephone's financial results increased the Group's operating income; however, this was partially offset by the consolidation of DBS.

G. Financing expenses

The Group's net financing expenses in 2005 amounted to approximately NIS 417 million, compared with approximately NIS 218 million in the prior year. Approximately NIS 133 million of the financing expenses is attributable to the first-time consolidation, as described in the introduction to this report above.

The effect of the changes in foreign currency and shekel rates on the Company's liabilities were partially neutralized by hedging transactions and by investment in financial assets.

The Group's financing expenses were influenced by income from the capital markets as a result of investments in marketable securities and by an increase in expenses due to an increase in the Group's total debt and to changes in exchange rates and the Consumer Price Index.

H. Other income (expenses)

Income amounting to approximately NIS 109 million was recorded in the Group's Other income (expenses) item, compared with income of approximately NIS 80 million in the prior year.
Most of the income in the prior year was a reduction in the provision for claims in respect of salary and pension components. The income recorded in the reporting period is primarily attributable to capital gains of approximately NIS 111 million and a reduction of NIS 83 million in the provision for early retirement (due to transfer to an insurance company). The income was partially offset by amortization of goodwill in respect of companies consolidated for the first time in the financial statements (see Note 8 to the financial statements).

I. Group's equity in losses of affiliates

The Group's equity in losses of affiliates in 2005 amounted to approximately NIS 13 million, compared with losses of approximately NIS 135 million recorded during the prior year. Most of the decrease during the reporting period derives from DBS becoming a consolidated company during 2004, and the results of its operations are presented in the financial statements on a consolidated basis, rather than by the equity method (see Note 8 to the financial statements).

The Company's auditors drew attention to the financial condition of DBS, and that in the opinion of DBS's management, based on its 2006 budget and an alternative business plan, there is a good chance that the sources of financing it will require in the coming year will be arranged.

J. Quarterly data – Consolidated statements (in NIS millions)

	2005	**Q4 2005**	**Q3 2005**	**Q2 2005**	**Q1 2005**
Income from telecommunication services	11,099	2,760	2,839	2,727	2,773
Operating and general expenses	7,194	1,852	1,836	1,742	1,764
Depreciation	2,331	582	588	583	578
Royalties to the government of Israel	257	62	65	65	65
	9,782	2,496	2,489	2,390	2,407
Operating income	1,317	264	350	337	366
Financing expenses, net	(417)	(145)	(107)	(110)	(55)
Earnings after financing expenses	900	119	243	227	311
Other income (expenses), net	109	(21)	(23)	65	88
Earnings before tax	1,009	98	220	292	399
Income tax	429	54	115	127	133

Earnings after income tax	580	44	105	165	266
Share in losses of affiliates	(13)	-	(2)	(8)	(3)
Minority share in earnings of a consolidated company	9	0	-	7	2
Accrued impact of change in accounting method	15	-	-	-	15
Net earnings	591	44	103	164	280

In the fourth quarter there was a decrease in the operating income and net earnings of the Group compared with the first three quarters of the year.

Operating income declined in the fourth quarter compared with the third quarter and the corresponding quarter, particularly because of a seasonal decline in revenues and an increase in general and operating expenses mainly due to a provision for a special benefit to employees for the period during the year (nine months) in which the Company was controlled by the State of Israel, as well as due to an adjustment to the provision for slow moving inventory.

In the fourth quarter there was an increase in financing expenses compared with the first three quarters of the year, primarily in the fixed-line domestic communications segment, mainly due to a rise in the Consumer Price Index, and a decrease in income from the Company's financial investments.

Results of operations during the quarters is influenced by the recording in the Other income (expenses) item.

3. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in 2005 amounted to approximately NIS 2,719 million, compared with approximately NIS 2,851 million in the prior year. With the elimination of an increase of approximately NIS 297 million which is attributable to first-time consolidation, cash flows from operating activities decreased by approximately NIS 429 million. The decrease derived mainly from the fixed-line domestic communications and cellular segments, and was mainly due to changes in the assets and liabilities items and the income and expenses items which do not involve cash flows.

Cash flows generated by operating activities are the principal source of financing of the Group's investments, which during the reporting period included, *inter alia*, approximately NIS 1,694 million in the development of communications infrastructure and approximately NIS 972 million in short-term investments.

During the year, the Group repaid approximately NIS 1,646 million in debts, of which approximately NIS 1,366 million was on account of long-term loans, approximately NIS 267 million of debentures and approximately NIS 13 million of short-term credit.

During the year, the Group raised new debt in a total amount of approximately NIS 2,177 million by an issuance of debentures and receipt of new long-term loans.

The average monthly short-term credit in 2005 was approximately NIS 98 million. The average monthly long-term liabilities in 2005 were approximately NIS 8,729 million.

Working capital as at December 31, 2005 was positive and amounted to approximately NIS 1,991 million, compared with working capital of approximately NIS 287 million on December 31, 2004, an increase of approximately NIS 1,704 million. The increase derives mainly from an improvement in working capital in the fixed-line domestic communications segment, in the amount of approximately NIS 994 million, resulting from a positive cash flow in total current liabilities which led to an increase in cash and short-term investment balances.

In the cellular segment, working capital improved compared with the prior year by approximately NIS 705 million, most of which derived from an increase in cash and short-term investments designated for the gradual repayment of bank loans. In addition, current liabilities decreased mainly due to a decrease in trade payables.

4. Group involvement in the community and donations

During the reporting period, the Group was active in the community through its involvement in social institutions and organizations such as the education system in underprivileged areas and the confrontation line. To mark the twentieth anniversary of its establishment, the Company initiated a campaign of donations to various organizations during a 12-month period commencing on February 20, 2004. The amount of the monthly donation is the higher of 5% of its call revenues on the twentieth day of each month of the campaign or NIS 200,000. During the reporting period, the Company donated a total of approximately NIS 231 thousand, for a total of NIS 2,792 thousand as part of this campaign.

In the Summer for the Community project, which the Company has initiated for two years now, 16-18 year old children of employees worked in medical institutions and community centers during the summer. The cost of the project to the Company was approximately NIS 1 million.

In addition, in 2005 Company employees volunteered in additional and diverse community involvement activities. For example, in the Parents and Children Learn About Computers and the Internet project, which has been in existence for 5 years, Company employees volunteer their time to mentor parents and children from underprivileged backgrounds on selected computer and internet issues. The cost of the project, in addition to the time invested by the volunteers, is approximately NIS 250 thousand annually.

In another project, about 500 employees of the Bezeq Group give workshops on Introduction to Modern Communications to junior high school students in a program that began in November 2005 in cooperation with the Ministry of Education.

Pelephone donated approximately NIS 675 thousand to various non-profit organizations during 2005.

During the reporting period, Bezeq International worked on behalf of underprivileged communities in Petach Tikva, adopted "lone" soldiers, adopted a fighting division and participated in conservation and educational projects. During the reporting period, the Company's expenses amounted to approximately NIS 500 thousand.

5. Details concerning market risks exposure management

Responsibility for the Company's market risks

The person responsible for management of the Company's market risks is the Deputy CEO and CFO, Mr. Ron Eilon. For details of his education and experience, see Section 13(C) in Chapter D of the Periodic Report.

Description of market risks and the Company's risk management policy

The Company is exposed to market risks as a result of changes in interest rates, exchange rates, inflation, the prices of raw materials and equipment and the prices of securities.

Interest rate – Since most of the Company's foreign-currency loans bear variable interest at the LIBOR rate plus a margin, the Company is exposed to changes in the LIBOR rate. This is an accounting exposure and can affect the financing expenses recorded by the Company as well as its cash flows. On the other hand, the fact that the interest rate is variable makes the fair value of these loans similar to their book value, thereby neutralizing possible economic exposure.

Company loans and debentures that are linked to the Consumer Price Index generally bear fixed interest and therefore a change in the interest rate will affect the fair value rather than the book value. This same is true of the euro-denominated debentures that the Company issued on an overseas stock exchange.

The Company has investments in marketable bonds that are recorded in its books at their market value. This market value is influenced by changes in the interest rates in the economy.

As of the date of this report, the Company does not hedge against the aforementioned exposures. It is not inconceivable, however, that it will do so under future market circumstances. Furthermore, the Company takes into account such influences when considering the types of loans it takes and in the management of its investment portfolio.

Exchange rates – Of itself, a change in the shekel exchange rate constitutes economic exposure in that it can affect the Company's future earnings and cash flows, mainly the repayment of currency-linked obligations and payments for the currency-linked purchase of equipment and raw materials.

In order to minimize this exposure, the Board of Directors decided that the Company should partially or fully hedge the accounting exposure deriving from all the balances recorded in the balance sheet. In the event of partial hedging, the unhedged exposure would not exceed an amount equivalent to $150 million, of which not more than the equivalent of $50 million would relate to currencies other than the U.S. dollar. In addition, the Company is able to implement additional hedging transactions from time to time against exposure to expected transactions during one year of operation, this being limited to a total volume not exceeding the equivalent of $100 million – of which not more than the equivalent of $30 million would relate to currencies other than the U.S. dollar. The reduction of exposure during the reporting period was accomplished by means of forward transactions of currencies hedged against shekels or against CPI-linked shekels. The time frame of the forward transactions is equal to or shorter than the time frame of the hedged exposure. We note that inherent in some of the Company's hedging transactions is a CPI-linked shekel interest rate, which increases the Company's exposure to the CPI. With the transition in 2004 to financial reporting and measurement based on nominal shekels, the Company has increased the volume of transactions against the nominal shekel.

The Company recorded no significant costs in making hedging transactions against the exchange rate, since they were made as forward transactions. The financial statements include financing expenses of approximately NIS 130 million from these hedging transactions.

Inflation – The rate of inflation affects the operating income and expenses of the Company during the year.

The Company's tariff updating mechanism as set forth in the Regulations allows tariffs to be updated according to the rise in the CPI (less a fixed efficiency factor) once a year. As a result, the annual rate of inflation and its spread over the year can have a material influence on the erosion of the Company's tariffs and on its revenues. On the other hand, the influence of the rate of inflation on the Company's expenses is reduced, since some of these expenses have direct or indirect linkage mechanisms.

In addition, the Company invests a considerable part of its cash balances in unlinked shekel deposits and mutual funds, and these deposits are exposed to changes in their real yield due to a change in the rate of inflation.

The low rate of inflation prevailing in Israel in recent years has considerably reduced the financial significance of this risk.

The Company has a surplus of liabilities over CPI-linked assets. In 2004 there was a transition of financial reporting and measurement to a nominal shekel basis. This transition increases the above-mentioned exposure, and in positive inflationary periods increases the Company’s financing expenses.

As part of its policy of minimizing exposure, the Company has made hedging transactions against the CPI so as to reduce this risk.

Prices of raw materials and equipment – Cash flows generated by the Company's operations are used partially for investment in equipment. The prices of equipment are affected by the indices to which they are linked, including sectoral price indices, exchange rates and global prices. The Company is not protected against this exposure.

Prices of securities – The Company invests some of its financial balances in securities. The composition and amount of the securities portfolio are determined by the Board of Directors of the Company. With the aim of preventing fluctuations in the portfolio's yield, the Board of Directors set investment principles whereby most of the investment will be in bonds, shekel deposits and interest-bearing foreign currency instruments, while the share component will not exceed 15% of the investment portfolio and will include shares invested in the TASE 100. The types of bonds and their proportional part in the portfolio were determined according to criteria based on linkage, redemption date and separation between government and non-government bonds. Additionally, a monetary ceiling was determined for the various types of investments.

Supervision and implementation of market risk management policy – Until the transfer of control in the Company, financial exposure reports at the Group level were submitted to a sub-committee of the Board of Directors which discussed them from time to time.

Recently, as part of the financial management policy at the Group level, a "Finance Team" was appointed and meets once a month, *inter alia*, to make recommendations on market risk policy and management to the boards of directors of the Company and the subsidiaries. These recommendations and regular updates on exposure to market risks are then discussed by those boards of directors from time to time, as necessary.

Description of the risks and their management in the consolidated companies – The persons responsible for management of the market risks in the principal consolidated companies are the Chief Financial Officers of those companies and at Pelephone – the Treasurer of the company. The consolidated companies make hedging transactions in accordance with the decisions and under the supervision of their boards of directors.

The financial statements include financing expenses of approximately NIS 117 million from hedging transactions made in the reporting period.

Linkage based report

Note 29 to the financial statements includes information on the linkage terms of the monetary balances of the Company and the Group as at December 31, 2005.

Positions in derivatives as at December 31, 2005 (consolidated)

(amounts are in NIS thousands)

Dollar / NIS								
	Nominal Value				**Fair Value - asset (liability)**			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging - recognized for accounting	361,336	-	-	-	45	-	-	
Hedging - not recognized for accounting	128,884	-	-	-	(1,644)	-	-	

Euro / NIS								
	Nominal Value				**Fair Value - asset (liability)**			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging - recognized for accounting	1,557,443	-	-	-	(68,944)	-	-	-

CPI / NIS								
	Nominal Value				**Fair Value - asset (liability)**			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging - recognized for accounting	930,000	-	300,000	-	583	-	(567)	-

6. Utilization of proceeds from securities

An offer for sale and issuance to the public through a prospectus was published on May 24, 2004. The application of proceeds from the offering will be decided by the Company from time to time in accordance with its requirements, including taking into account the necessity of replacing loans by early repayment. As at the date of approval of the financial statements there has been no need to replace such loans (except for a loan of NIS 5 million which was repaid by the Company before its due date).

7. Disclosure concerning internal auditor in a reporting corporation

(1) The Internal auditor of the Company

Name: Daniel Freedman

Date of commencement of office: August 1, 2003 (appointed as substitute until December 2, 2003)

Qualifications: BA in Accounting (Hebrew University); MA in Economics and Statistics (Hebrew University); CIA (Certified Internal Auditor – USA); CISA (Certified Information Systems Auditor) – USA);

Internal auditing experience: 21 years in various internal auditing positions.

Employment basis: Senior employee with personal contract, full-time.

(2) Audit department employees

The internal auditing department has 16 employees, including the internal auditor, who is a full-time employee. Fifteen of the department's auditing employees have academic degrees in the following fields: accounting, law, economics, business administration, statistics, criminology, electrical engineering, political science. Three of the employees, including the internal auditor, have international certifications in internal auditing (CIA and/or CISA).

(3) Considerations in determining the internal audit work program

The guiding principle behind the annual work program for the internal audit is the risk inherent in the Company's processes and operations. In order to assess the risks, the audit prepares a 'control risk survey' of the Company every year. As part of this survey, the audit examines, in cooperation with the Company's senior management, the material exposures and risks in the Company's operations and the control environment existing for the management of these risks. The survey's findings are used to compile the topics for the annual and multi-year work program.

Additional considerations taken into account in the compilation of the work program are:

A. Reasonable coverage of all the Company's areas of business (finance; sales and marketing; personnel and payroll, investments, mergers and acquisitions; safety and security; information technology – IT; economics and logistics; engineering and planning).

B. Preparation of follow-up checks – at the request of the Board's Audit Committee or the recommendation of the Internal Auditor.

C. Preparation of reports to follow up the implementation of decisions made by management and the Audit Committee during the two years preceding the year of account.

In addition to the subjects determined in the annual work program, the audit prepares 'special examinations'. These examinations are not included in the work program, and are prepared at the request of the Chairman of the Board of Directors, Chairman of the Audit Committee or the CEO.

(4) The audit's response to corporations comprising a material holding

In all the corporations representing material holdings of the Company, there are internal auditors (either as employees or outsourced). The audit reports are discussed in the audit committees and/or Boards of Directors of these corporations, on which senior executives of the Company serve. The Company auditor regularly receives the audit reports of the corporations which are fully held by the Company: Bezeq Online Ltd., Bezeq International Ltd. and BezeqCall Communications Ltd., and submits a summary of their material findings to the Chairman of the Board of Directors, the CEO and the Chairman of the Audit Committee.

At the request of the Chairman of the Board of Directors, the internal auditor prepares special audit examinations for the affiliated companies. During the reporting year, the internal auditor conducted three examinations: Two at DBS and one at BezeqCall Communications Ltd. These examinations are not part of the work program of the affiliated companies, but additional to it.

(5) Work standards

The Bezeq internal audit is prepared pursuant to the binding standards of the IIA (Institute of Internal Auditors). In 2004 an external audit investigation of Bezeq's internal audit department was carried out, as required by Standard 1312 of the IIA. The conclusion of this investigation was that the work of the Company's internal audit department is carried out in accordance with accepted professional internal audit standards.

(6) Organizational officer responsible for the internal auditor

According to a resolution of the Company's Board of Directors, the Chairman of the Board is the organizational officer responsible for the internal auditor.

(7) Dates for submission of the audit reports

The internal auditor routinely submits the audit reports during the reporting period to the Chairman of the Board of Directors, the CEO, the Chairman of the Audit Committee and the committee members. During the reporting period, 26 reports were submitted, of which two were follow-up reports resulting from implementation of decisions made by management and the Audit Committee in 2003 and 2004.

(8) Dates on which the Audit Committee convenes

The Board's Audit Committee regularly discusses the audit reports submitted by the internal auditor during the reporting period. Over the course of the year, the Committee held 17 meetings. The following table presents the meeting dates during the reporting period, divided into quarters:

First quarter	Second quarter	Third quarter	Fourth quarter
January 4, 2005	April 14, 2005	July 7, 2005	December 8, 2005
January 20, 2005	April 20, 2005	July 12, 2005	January 1, 2006 This meeting was held instead of the meeting that had been scheduled for December 2005 and was postponed.
February 6, 2005	May 3, 2005	July 21, 2005	
February 17, 2005	May 9, 2005	September 13, 2005	
March 14, 2005	June 28, 2005		
March 22, 2005			

24 audit reports were discussed at these meetings. About half of the reports discussed were published during the reporting period and half at the end of the prior reporting period. In addition to discussions of the audit reports, the committee discussed subjects that it is obligated by law to discuss.

(9) Authority and responsibility of the internal auditor

9.1 The authority and responsibility of the Company's internal auditor are determined in the procedure "The Internal Auditor of the Company". The procedure was revised and approved by the Board's Audit Committee on January 4, 2005.

9.2 Duties of the internal auditor according to the procedure

a. To examine whether the activities of the Company, its officers and senior employees are proper from the perspective of upholding the law and proper business management.

b. To verify that the Company's operations were carried out lawfully, by a qualified person, while adhering to principles of efficiency, thrift and purity of ethics, and to ensure that they contribute to achievement of the goals defined.

c. To indicate deficiencies in the management of the business of the Company.

d. To examine the authenticity and quality of the financial and management information.

e. To inspect the cash management, the Company's liabilities and arrangements to safeguard the Company's assets and their entirety, and their operative efficiency and use.

f. To check whether the Company's decisions, including at the Board and its committee levels, were made in accordance with proper procedures.

g. To inspect the Company's information systems and information security system – in the computer environment and in the computer systems.

h. To examine the correctness of the Company's transactions with its senior employees, with their families or with corporations under their control.

i. To examine the correctness and effectiveness of the Company's procedures for entering into commitments.

j. To investigate complaints made by Company employees and complaints from the public regarding damage to purity of ethics and proper procedures.

k. To recommend that the Audit Committee determine or amend procedures on significant topics.

l. To expose deficiencies, identify the reasons for their existence, and note the causes responsible for them.

m. To make proposals for correcting the deficiencies and preventing their recurrence.

n. To re-audit in order to follow up implementation of the recommendations in the various departments.

9.3 <u>Authorities of the Company's internal auditor in accordance with the procedure</u>

a. The Company's internal auditor may demand and receive any information, explanation and document required at his discretion for the performance of his duty, and every Company employee is obliged to provide any document or information at the Company's internal auditor's first request. Every Company employee requested to provide information to the auditor is required to comply with the request at the time and in the manner determined therefore.

b. The internal auditor is authorized to perform an audit at any time, with a scope that he deems appropriate, in any of the Company's departments.

c. The manager and employees of the audited department will allow the internal auditor and his staff to perform the audit and will assist them with any request.

d. For performance of his duty, the internal auditor shall be granted access to any ordinary or computer databank, to any database and to any automated or non-automated data processing work program in the Company.

e. The internal auditor may enter and inspect any of the Company's assets.

f. The above authorities are also granted to audit department staff and to any person acting on behalf of the internal auditor.

(10) <u>Opinion of the Board of Directors</u>

"Based on Sections 1-9 above, we, the members of the Company's Board of Directors, believe that, based on the reports we received from the internal auditor, the scope of the Company audit performed in 2005, the nature and continuity of the internal auditor's activities, and the work program are reasonable under the circumstances and they achieve the objectives of the audit."

8. Critical accounting estimates

The preparation of the financial statements according to accepted accounting principles obligates the management of the Company to make estimates and assessments that influence the reported values of assets and liabilities, income and expenses, and disclosure relating to contingent assets and liabilities.

Management bases its estimates and assessments on past experience and on additional factors which it believes are relevant, taking into account the circumstances. The actual results can differ from those assessments on various assumptions and conditions. Management has identified the most critical assessments and estimates that require significant discretion in preparing the consolidated financial statements. Management believes that these assessments and estimates are critical because every change in them and in the assumptions has the potential to materially affect the financial statements.

Estimated useful life of fixed assets

The estimated useful lives of fixed assets serve to determine the depreciation expenses that will be recorded in the reporting period.

The main part of the telecommunications infrastructure is managed in accordance with asset groups. The depreciation rates are based on the average useful life of an asset group and not of each individual asset. The useful life of an asset group is examined periodically and is based on past experience, taking into consideration expected technological changes, Company plans or other changes. If such changes take place earlier than expected or differently from expected, the remaining useful life of such assets may be shortened. This results in an increase in future depreciation expenses. If the changes take place later than expected, the remaining useful life may be extended, and this results in a decrease in the depreciation expense. In light of the importance of the Group's depreciation expenses in respect of the above changes, the effect on the operating results and the financial condition of the Group can be extremely significant. In addition, in accordance with the instructions of Accounting Standard No. 15 of the Accounting Standards Institute, the possibility of decreasing the value of the asset is reviewed when there is an indication of a decrease in the recoverable value of the asset.

Regarding a change in the estimated useful life of a fixed asset and the outcome of the review of a possible decrease in the value of the Group – see Note 9 to the financial statements.

Period of amortization of goodwill

Pursuant to Accounting Standard No. 20 of the Accounting Standards Institute, goodwill will be systematically amortized over its useful life. The amortization period reflects the best estimate of the period in which future economic benefits are expected to derive to the entity from the goodwill. The amortization period shall not exceed 20 years.

The period during which future economic benefits are expected to derive to the Company is estimated by management. Use of other assumptions is likely to result in a different estimate of the period in which economic benefits from the goodwill are expected.

For the amortization period and changes thereto – see Note 2(D) to the financial statements.

Liability for employee severance benefits

Liability for employee severance benefits included in the financial statements is based on numerous assumptions and estimates. Material assumptions and estimates are linked to early retirement plans. This provision is based on actuarial calculations which include many calculation assumptions which can be different in practice. The assumptions relate, *inter alia*, to interest rates for capitalization, mortality tables, wage creep – for details, see the actuary's letter attached to the financial statements. Some of the severance pay liabilities, such as a provision for redemption of sick leave, a provision severance and a provision employee claims, are also based on assumptions and estimates which are likely to be clarified in the future.

With regard to changes in estimates in respect of the cessation of the employer-employee relationship, see Note 16 to the financial statements.

Deferred taxes

Deferred taxes are calculated at the tax rate expected to be in effect on their date of utilization. The tax benefit is included in the financial statements since the Company's business plans anticipate realization of the tax benefit. In the nature of things, actual business results can differ from business plans, and this can affect the future realization of the tax benefit.

See Note 11 (D) and Note 11 (F) to the financial statements.

Contingent liabilities

The Group's companies have pending liabilities in amounts for which the possible maximum exposure is considerable. Among these, class actions of extremely significant amounts are pending against Group companies.

The Company makes regular estimates of the potential liabilities associated with every claim. It is naturally very difficult to determine the outcomes of the claims. The Company uses its best judgment and the assessments of its legal advisers to determine whether it is reasonable for the Company to bear the costs of settling claims and whether they can be reasonably estimated.

Taking into consideration the uncertainty inherent in legal claims, it is possible that all or some of them will be concluded with charges for the Company, in amounts materially different from the provisions included in the financial statements, if any.

For details of contingent liabilities, see Note 19 to the financial statements.

9. Directors with accounting and financial expertise

A. The Company's Board of Directors determined that the minimum number of directors who have accounting and financial expertise, as required by the provisions of the Companies Law, is one (and together with the outside directors – two). The Board of Directors believes that this number will enable it to fulfill the duties imposed upon it by law and by the documents of association, including review of the financial condition of the Company and preparing and approving the financial statements, taking into consideration the volume and complexity of its operations.

B. Serving directors who have the above skills are Yigal Cohen-Orgad (external director) and Menachem Inbar. For information about their relevant education and experience, see Sections 12(g) and 12(h) in Chapter D of the Periodic Report.

10. Miscellaneous

A. Disclosure concerning the remuneration of the external auditor

Below are the fees paid to the auditors of the main companies in the group in respect of auditing services for 2005:

- The Company – Somekh Chaikin – approximately NIS 1,300 thousand.
- Pelephone – Kesselman & Kesselman – approximately NIS 440,000 in fees for auditing services and NIS 65,000 for other services.
- DBS – Kesselman & Kesselman – approximately NIS 500,000 for auditing services and NIS 124,000 for other services.
- Bezeq International – Brightman Almagor & Co. – approximately NIS 370,000, which includes tax services for 2004.

B. Adoption of Ethical Code

On April 20, 2005, the Company's Board of Directors adopted an ethical code for its business practices. The ethical code establishes principles and rules of behavior to direct the actions of senior officers, managers and employees. The Deputy VP of Human Resources was appointed to be the person in the Company responsible for implementation of the provisions of the code of ethics.

C. Peer Review

On April 20, 2005, the Securities Authority published a directive requiring disclosure in the matter of giving consent to a peer review, the purpose of which, according to the directive, is to encourage a process of control of the work of external auditors. The directive raises questions, including legal questions, mainly concerning the confidentiality of the material submitted to the accountants and the harm that a company could suffer as a result of the exposure of such material. Since the legal problems of this kind have not yet been resolved, the Company has not yet made a decision on the matter.

D. Sale of controlling interest

On October 11, 2005, the process of selling the controlling interest and transfer of the State's holdings in the Company to Ap.Sb.Ar Holdings Ltd. was completed (see Note 1F to the financial statements). Upon the closing of the transaction, all the directors representing the State resigned from the Board of Directors, and the appointment of new directors, as approved earlier by the General Meeting of the shareholders, took effect. The external directors who served on the Board prior to closing the transaction will continue to serve on the Board.

E. Chairman of the Board and CEO

Commencing October 11, 2005, Moshe Arkin serves as Chairman of the Board of Directors and Yacov Gelbard as CEO.

We thank the managers of the Group companies, its employees and the shareholders.

Moshe Arkin **Chairman of the Board of Directors**	**Yacov Gelbard** **President & CEO**

Chapter C – Financial Statements

"BEZEQ" THE ISRAEL TELECOMMUNICATION CORP. LIMITED

FINANCIAL STATEMENTS

DECEMBER 31, 2005

Contents

Somekh Chaikin

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Auditor's Report to the Shareholders of
"Bezeq" The Israel Telecommunication Corp. Limited

We have audited the accompanying balance sheets of "Bezeq" The Israel Telecommunication Corp. Limited (the Company) as at December 31, 2005 and 2004, the consolidated balance sheets as at such dates and the related statements of income, changes in shareholders' equity and cash flows for each of the three years the last of which ended on December 31, 2005. These financial statements are the responsibility of the Company's Board of Directors and its Management. Our responsibility is to express an opinion on these financial statements based on our audits.

We did not audit the financial statements of consolidated subsidiaries, whose assets included in the consolidation constitute approximately 37.7% and approximately 36.3% of the total consolidated assets as at December 31, 2005 and 2004 and whose revenues included in the consolidation constitute approximately 60%, 49% and 37% of the total consolidated revenues for the years ended December 31, 2005, 2004, and 2003, respectively. Furthermore, we did not audit the financial statements of affiliates in which the investment was approximately NIS 75 million and approximately NIS 70 million as at December 31, 2005 and 2004, respectively, and the Group's equity in their operating losses is approximately NIS 13 million, approximately NIS 135 million and approximately NIS 341 million for the years ended December 31, 2005, 2004 and 2003, respectively. The financial statements of those companies were audited by other auditors whose reports thereon were furnished to us and our opinion, insofar as it relates to amounts emanating from the financial statements of such companies, is based solely on the said reports of the other auditors.

We conducted our audits in accordance with generally accepted auditing standards, including standards prescribed by the Auditors' Regulations (Manner of Auditor's Performance), 1973. Such standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Board of Directors and by Management of the Company, as well as evaluating the overall financial statement presentation. We believe that our audits and the reports of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and on the reports of the other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of the Company and the consolidated financial position of the Company and its subsidiaries as at December 31, 2005 and 2004 and the results of their operations, the changes in shareholders' equity and their cash flows for each of the three years the last of which ended December 31, 2005, in conformity with generally accepted accounting principles. Furthermore, in our opinion, the financial statements referred to above are prepared in accordance with the Securities Regulations (Preparation of annual financial statements), 1993.

As explained in Note 2B, the financial statements for dates and reporting periods subsequent to December 31, 2003 are stated in reported amounts, in accordance with the accounting standards of the Israel Accounting Standards Board. The financial statements for dates and reporting periods that ended through the aforementioned date are stated in values that were adjusted to that date according to the changes in the general purchasing power of the Israeli currency, in accordance with opinions of the Institute of Certified Public Accountants in Israel.

Without qualifying our opinion, we draw attention to the uncertainties relating to the following matters, the maximum possible exposure of which is significant:

1. The continuing opening of the communications sector to competition, changes in the tariffs and their effect on the Company's financial position and operating results, as described in Note 1.

2. A program for early retirement, as described in Note 16D.

3. Claims made against the Company and against investee companies, as described in Note 19A.

4. The financial position of a consolidated company, as mentioned in Note 8E. In the opinion of the Management of the consolidated company, based on the 2006 work plan and on the alternative business plan, the chances of arranging sources of finance required by the consolidated company in the forthcoming year are good.

Somekh Chaikin
Certified Public Accountants (Isr.)
A member firm of KPMG International

March 1, 2006

Balance Sheets

		Consolidated		Company	
		December 31 2005	December 31 2004	December 31 2005	December 31 2004
	Note	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Current assets					
Cash and cash equivalents	3	**2,158,773**	1,457,107	**1,679,244**	1,327,731
Short-term investments	4	**2,398,525**	1,287,809	**2,045,901**	1,285,920
Trade receivables	5	**2,113,512**	2,115,070	**896,415**	970,766
Other receivables and debit balances	6	**321,507**	416,113	**444,403**	370,284
Inventory		**220,404**	314,549	**–**	–
		7,212,721	5,590,648	**5,065,963**	3,954,701
Materials and spare parts		**88,881**	130,922	**88,881**	130,922
Broadcasting rights					
Cost		**238,260**	234,757	**–**	–
Less – rights utilized		**83,760**	94,261	**–**	–
		154,500	140,496	**–**	–
Investments and long-term receivables					
Investments, deposits and debit balances	7	**766,840**	872,575	**401,096**	570,541
Investments in investee companies	8	**75,467**	70,308	**5,945,899**	6,484,476
		842,307	942,883	**6,346,995**	7,055,017
Fixed assets	9				
Cost		**30,627,629**	34,311,281	**21,286,880**	22,124,083
Less – accumulated depreciation		**20,684,981**	23,570,947	**15,766,843**	15,993,634
		9,942,648	10,740,334	**5,520,037**	6,130,449
Other assets					
Goodwill		**1,699,546**	1,792,658	**–**	–
Deferred charges and other assets	10	**380,483**	387,904	**10,056**	13,434
Deferred taxes	11	**344,786**	446,136	**315,708**	339,280
		2,424,815	2,626,698	**325,764**	352,714
		20,665,872	20,171,981	**17,347,640**	17,623,803

	Note	Consolidated December 31 2005 NIS thousands	Consolidated December 31 2004 NIS thousands	Company December 31 2005 NIS thousands	Company December 31 2004 NIS thousands
Current liabilities					
Bank credit	12	**75,191**	88,102	**–**	–
Current maturities of:					
Long-term bank loans	13	**1,262,583**	1,304,916	**531,402**	473,578
Debentures	14	**527,167**	240,481	**410,827**	210,481
Trade payables	15	**1,400,714**	1,675,569	**540,459**	648,218
Employee severance benefits, net	16	**567,878**	592,474	**567,878**	592,474
Other current liabilities	17	**1,387,955**	1,402,140	**901,642**	909,194
		5,221,488	5,303,682	**2,952,208**	2,833,945
Long-term liabilities:					
Long-term loans	13	**2,151,960**	2,860,934	**34,522**	529,734
Debentures	14	**4,903,056**	3,824,539	**6,012,584**	6,114,628
Employee severance benefits, net	16	**297,427**	680,096	**274,883**	658,355
Other long-term liabilities	18	**34,081**	47,375	**15,583**	21,374
Loans extended by the minority in a consolidated company:					
Loans		**1,114,498**	1,057,988	**–**	–
Less – minority share in deficit of a consolidated company		**(1,114,498)**	(1,057,988)	**–**	–
		7,386,524	7,412,944	**6,337,572**	7,324,091
Minority rights		**–**	(10,412)	**–**	–
Contingent liabilities	19				
Shareholders' equity	20	**8,057,860**	7,465,767	**8,057,860**	7,465,767
		20,665,872	20,171,981	**17,347,640**	17,623,803

Moshe Arkin	**Yacov Gelbard**	**Ron Eilon**
Chairman of the Board	President & CEO	Deputy CEO and CFO

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2B.

Date of approval of the financial statements: March 1, 2006.

The notes to the financial statements are an integral part thereof.

Statements of Operations for the Year Ended December 31

		Consolidated			Company		
		2005	2004	2003	2005	2004	2003
		Reported amounts*		Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*		Adjusted for the effects of inflation in shekels of December 2003
	Note	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues	21	**11,098,686**	9,269,804	7,981,268	**4,723,734**	4,959,691	5,230,561
Costs and expenses							
General and operating expenses	22	**7,193,468**	5,565,090	4,485,300	**2,346,451**	2,347,448	2,366,547
Depreciation	9	**2,330,711**	2,092,475	2,160,011	**1,390,435**	1,495,909	1,776,279
Royalties to the State of Israel		**257,429**	220,691	242,608	**135,575**	145,318	181,116
		9,781,608	7,878,256	6,887,919	**3,872,461**	3,988,675	4,323,942
Operating income		**1,317,078**	1,391,548	1,093,349	**851,273**	971,016	906,619
Financing expenses, net	23	**(417,309)**	(217,529)	(157,522)	**(80,897)**	(93,216)	(62,372)
Earnings after financing expenses		**899,769**	1,174,019	935,827	**770,376**	877,800	844,247
Other income (expenses), net	24	**109,386**	79,680	(983,178)	**201,012**	109,904	(846,948)
Earnings (loss) before income tax		**1,009,155**	1,253,699	(47,351)	**971,388**	987,704	(2,701)
Income tax	11	**(429,594)**	(497,485)	(48,013)	**(332,118)**	(387,079)	(33,513)
Earnings (loss) after income tax		**579,561**	756,214	(95,364)	**639,270**	600,625	(36,214)
Equity in earnings (losses) of investee companies	8	**(12,645)**	(134,773)	(343,334)	**(63,412)**	20,200	(401,622)
Minority share in loss (earnings) of a consolidated company		**8,942**	(616)	862	**–**	–	–
Earnings before the cumulative effect of a change in accounting method		**575,858**	620,825	(437,836)	**575,858**	620,825	(437,836)
Cumulative effect of a change in accounting method as at the beginning of the year**	11	**15,000**	–	–	**15,000**	–	–
Net earnings		**590,858**	620,825	(437,836)	**590,858**	620,825	(437,836)

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2B
** See Note 2P

The notes to the financial statements are an integral part thereof.

Statements of Operations for the Year Ended December 31 (contd.)

	Consolidated			Company		
	2005	**2004**	**2003**	**2005**	**2004**	**2003**
	Reported amounts*		**Adjusted for the effects of inflation in shekels of December 2003**	**Reported amounts***		**Adjusted for the effects of inflation in shekels of December 2003**
	NIS thousands	**NIS thousands**	**NIS thousands**	**NIS thousands**	**NIS thousands**	**NIS thousands**
Primary and diluted earnings per NIS 1 par value of common shares (in NIS):						
Earnings before the cumulative effect of a change in accounting method	**0.222**	0.238	(0.179)	0.222	0.238	(0.179)
Cumulative effect of a change in accounting method	**0.005**	–	–	**0.005**	–	–
Net earnings per share	**0.227**	0.238	(0.179)	**0.227**	0.238	(0.179)

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2B

** See Note 2P

The notes to the financial statements are an integral part thereof.

Statements of Changes in Shareholders' Equity

	Share capital	Capital reserve – share premium	Capital reserve in respect of transactions between the Company and a controlling shareholder	Dividend proposed after the balance sheet date	Retained earnings (deficit)	Total
	Adjusted for the effects of inflation in shekels of December 2003					
	NIS thousands					
Balance as at January 1, 2003	6,116,378	938,134	37,775	186,416	(688,623)	6,590,080
Changes in 2003 –						
Net loss	–	–	–	–	(437,836)	(437,836)
Dividend paid	–	–	–	(186,416)	1,070	(185,346)
Allotment of shares	192,755	685,289	–	–	–	878,044
Balance as at December 31, 2003	6,309,133	1,623,423	37,775	–	(1,125,389)	6,844,942

	Share capital	Capital reserve – share premium	Capital reserve in respect of transactions between the Company and a controlling shareholder	Dividend proposed after the balance sheet date	Retained earnings (deficit)	Total
	Reported amounts*					
	NIS thousands					
Balance as at January 1, 2004	6,309,133	1,623,423	37,775	–	(1,125,389)	6,844,942
Changes in 2004 –						
Net earnings	–	–	–	–	620,825	620,825
Balance as at December 31, 2004	6,309,133	1,623,423	37,775	–	(504,564)	7,465,767
Changes in 2005 –						
Net earnings					**590,858**	**590,858**
Payment by the State for Company privatization	**–**	**–**	**1,235**	**–**	**–**	**1,235**
Dividend proposed for payment	**–**	**–**	**–**	**1,200,000**	**(1,200,000)**	**–**
Balance as at December 31, 2005	**6,309,133**	**1,623,423**	**39,010**	**1,200,000**	**(1,113,706)**	**8,057,860**

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2B.

The notes to the financial statements are an integral part thereof.

Statements of Cash Flows for the Year Ended December 31

	Consolidated			Company		
	2005	2004	2003	2005	2004	2003
	Reported amounts*		Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands			NIS thousands		
Cash flows from operating activities						
Net earnings (loss)	**590,858**	620,825	(437,836)	**590,858**	620,825	(437,836)
Adjustments to reconcile net earnings (loss) to net cash flows generated by operating activities (see A below)	**2,127,730**	2,229,782	3,129,581	**929,074**	1,490,414	2,552,780
Cash flow generated by operating activities	**2,718,588**	2,850,607	2,691,745	**1,519,932**	2,111,239	2,114,944
Cash flows from investing activities						
Investment in fixed assets	**(1,694,071)**	(1,650,557)	(1,413,803)	**(814,783)**	(842,224)	(853,166)
Proceeds from disposal of fixed assets and sale of operations	**147,810**	131,576	86,492	**117,121**	44,897	7,742
Investment in long-term deposits and investments	**(10,068)**	(42,064)	(159,564)	**(10,068)**	(42,064)	(150,808)
Realization of long-term deposits and investments	**91,431**	18,094	77,216	**91,431**	18,094	67,176
(Increase) decrease in short-term investments, net	**(972,260)**	135,602	(107,137)	**(627,681)**	135,509	(107,137)
Acquisition of companies consolidated for the first time (see C below)	**–**	(246,935)	–	**–**	–	–
Investment in investee companies	**(18,836)**	(142,753)	(190,037)	**(74,173)**	(2,376,699)	(188,542)
Repayment of loan to subsidiary	**–**	–	–	**539,860**	–	–
Dividend from a subsidiary	**–**	–	–	**–**	18,838	–
Investments in other assets	**(91,893)**	(130,700)	(51,124)	**–**	(2,598)	–
Net cash outflow used for investment activities	**(2,547,887)**	(1,927,737)	(1,757,957)	**(778,293)**	(3,046,247)	(1,224,735)
Cash flows from financing activities						
Issue of other debentures (after deduction of issue expenses)	**1,702,265**	1,528,092	–	**330,993**	1,322,171	–
Repayment of other debentures	**(267,332)**	(601,481)	(207,623)	**(211,752)**	(601,481)	(207,623)
Receipt of long-term loans	**474,521**	314,900	493,191	**–**	–	–
Repayment of long-term loans	**(1,365,578)**	(2,605,012)	(557,302)	**(509,367)**	(354,469)	(378,828)
Repayment of short-term bank credit, net	**(12,911)**	(56,612)	(374,137)	**–**	–	–
Proceeds from allotment of shares	**–**	–	878,044	**–**	–	878,044
Dividend paid	**–**	–	(185,346)	**–**	–	(185,346)
Net cash generated by (used for) financing activities	**530,965**	(1,420,113)	46,827	**(390,126)**	366,221	106,247
Increase (decrease) in cash and cash equivalents	**701,666**	(497,243)	980,615	**351,513**	(568,787)	996,456
Cash and cash equivalents at beginning of year	**1,457,107**	1,954,350	973,735	**1,327,731**	1,896,518	900,062
Cash and cash equivalents at end of year	**2,158,773**	1,457,107	1,954,350	**1,679,244**	1,327,731	1,896,518

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2B

The notes to the financial statements are an integral part thereof.

Statements of Cash Flows for the Year Ended December 31 (contd.)

	Consolidated			Company		
	2005	2004	2003	2005	2004	2003
	Reported amounts*		Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands			NIS thousands		
A – Adjustments to reconcile net earnings (loss) to net cash flows generated by operating activities						
Revenues and expenses not involving cash flows:						
Depreciation	**2,330,711**	2,092,475	2,160,011	**1,390,435**	1,495,909	1,776,279
Disposal of assets and provision for impairment of fixed assets	**–**	–	327,295	**–**	–	198,686
Deferred taxes	**144,035**	219,975	(137,670)	**50,397**	113,330	(182,167)
Company's equity in (earnings) losses of affiliated companies	**12,645**	134,773	343,334	**63,412**	(20,200)	401,622
Minority share in losses (gains) of a consolidated company	**(8,942)**	616	(862)	**–**	–	–
Increase (decrease) in employee severance benefits, net	**(407,265)**	(110,334)	46,488	**(408,068)**	(112,974)	47,662
Gain from disposal of fixed assets	**(5,715)**	(7,338)	(1,634)	**(5,385)**	(5,674)	(1,570)
Gain from sale of an operation	**(103,869)**	(35,033)	–	**(103,869)**	(35,033)	–
Provision for decrease in value of investments	**5,868**	26,000	14,603	**5,868**	26,000	14,603
Erosion (appreciation) of and interest on long-term deposits and investments	**22,170**	31,199	36,407	**22,118**	(6,023)	36,407
Appreciation of short-term investments, net	**(60,396)**	(10,584)	(75,381)	**(52,424)**	(10,555)	(75,378)
Appreciation (erosion) of long-term liabilities:						
Other debentures	**(69,730)**	115,674	207,133	**(20,939)**	115,674	207,133
Long-term loans and other long-term liabilities	**129,032**	(17,104)	(77,647)	**(118,565)**	(9,971)	(82,015)
Amortization of other assets and deferred expenses	**196,015**	110,083	127,191	**4,618**	6,098	(8,466)
Changes in asset and liability items:						
Increase in broadcasting rights	**(14,004)**	(17,516)	–	**–**	–	–
Decrease (increase) in trade receivables	**(63,298)**	52,827	29,835	**74,351**	50,501	67,096
Decrease (increase) in other receivables and debit balances	**24,600**	(8,223)	129,706	**44,375**	(54,988)	163,158
Decrease (increase) in inventory	**75,943**	(122,824)	78,083	**–**	–	–
Decrease (increase) in materials and spare parts	**24,952**	625	(260)	**24,952**	625	(260)
Decrease in trade payables	**(112,461)**	(102,466)	(123,852)	**(63,777)**	(23,124)	(30,925)
Increase (decrease) in other current liabilities	**20,733**	(126,652)	63,054	**27,366**	(26,451)	45,460
Increase (decrease) in deferred revenues	**(13,294)**	3,609	(16,253)	**(5,791)**	(12,730)	(24,545)
	2,127,730	2,229,782	3,129,581	**929,074**	1,490,414	2,552,780

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2B

The notes to the financial statements are an integral part thereof.

Statements of Cash Flows for the Year Ended December 31 (contd.)

	Consolidated			Company		
	2005	2004	2003	2005	2004	2003
	Reported amounts*		Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands			NIS thousands		
B – Non–cash transactions						
Acquisition of fixed assets, other assets, materials and spare parts on credit	**124,719**	102,687	313,119	**17,089**	25,553	180,463
Sale of fixed assets on credit	**17,089**	1,196	–	**–**	1,196	–
Investment against a loan to a consolidated company	**–**	–	–	**–**	2,560,089	–
C – Company consolidated for the first time and assumption of full control of a proportionally consolidated company						
Operating capital (excluding cash and cash equivalents)	**–**	2,057,632	–	**–**	–	–
Fixed assets	**–**	(2,967,819)	–	**–**	–	–
Long-term liabilities	**–**	2,322,740	–	**–**	–	–
Minority loans to a consolidated company	**–**	1,048,637	–	**–**	–	–
Less minority share in the deficit	**–**	(1,048,637)	–	**–**	–	–
Minority rights as of acquisition date	**–**	(16,549)	–	**–**	–	–
Investment in an affiliate	**–**	178,339	–	**–**	–	–
Goodwill	**–**	(1,821,278)	–	**–**	–	–
	–	(246,935)	–	**–**	–	–

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2B.

The notes to the financial statements are an integral part thereof.

NOTE 1 – GENERAL

A. The financial statements have been prepared in conformity with the generally accepted accounting principles as required and in accordance with the Securities Regulations (Preparation of annual financial statements), 5753-1993.

B. "Bezeq" The Israel Telecommunication Corp. Limited ("the Company") is a public company whose shares are traded on the Tel Aviv Stock Exchange. Commencing October 11, 2005, control in the Company was transferred from the State of Israel, as described in Note 1F. The Company operates under a general license for implementing telecommunications activities and providing telecommunications services, which was granted pursuant to the Communications Law (Telecommunications and broadcasts), 5742-1982 ("the Communications Law"). The Company, together with the subsidiaries ("the Group"), is a main provider of communications services in Israel.

C. Most of the Group companies are required to pay royalties to the Government of Israel. Since January 2001, the revenue base on which the royalties are calculated has been broadened, together with a gradual reduction of the royalty rate, until a uniform rate is attained for all communications operators. The rate of royalties in 2003 was 4% and from 2004 onwards, it was lowered to 3.5%. The Ministries of Communications and Finance intend to act to amend the relevant regulations so that effective from January 1, 2006, a reduction of 0.5% will be made each year in the rate of the royalties paid by the said licensees operating in domestic fixed-line telecommunications, international telecommunications and cellular services, until reaching a rate of 1% in the year 2010. The regulations have not yet been amended.

D. The Company was declared a monopoly in the principal fields in which it operates. An appeal filed by the Company against the non-revocation of the declaration of the Company as a monopoly in the basic telephony field, is pending in the Antitrust Tribunal.

E. All the segments of operation of the Group operate in a competitive environment. The Group's operations are generally subject to administrative regulation and supervision. The principal changes that occurred during the period of the financial statements are described below:

(1) Domestic fixed-line communication services

a. Most of the tariffs for the Company's services are set according to Section 15 of the Communications Law and are updated in accordance with the regulations. Tariff updates are based on the change in the Consumer Price Index less a depreciation factor which is set at minus 2.5% as long as the average growth rate of the Company is within a range of minus 1% to minus 3% per year (the depreciation factor will be reduced by one half of one percent with each decrease of one percent in the growth rate beyond minus 3%, and will increase by one half of one percent with each rise of one percent in the growth rate beyond minus 1% continuously). This tariff arrangement will remain in force until December 31, 2007, with an option to extend it for an additional year.

On June 1, 2005, the Company's controlled tariffs were reduced by an average rate of approximately 2.2%. The said reduction was based on a change of approximately 1.2% in the Consumer Price Index and an average efficiency factor at a rate of approximately 3.4%. It should be noted that the update includes, *inter alia*, a reduction of approximately 3.2% in the call tariffs and an increase of approximately 1.2% in the user charges. The reduction also included the amendment of the calculation method of the annual efficiency factor. It should be noted that the interconnect tariffs were reduced by a rate of 3.2%, effective from September 1, 2005.

Following the reduction in the rate of VAT to 16.5% in September 2005, the Company's tariffs were updated accordingly. Subsequently, part of the Company's tariffs were amended (and published in the regulations) in effect from November 1, 2005, in order to maintain "round" tariffs for these services, while including the new rate of VAT.

NOTE 1 – GENERAL (CONTD.)

E (CONTD.)

(1) Domestic fixed-line communication services (contd.)

b. In November 2003, a partnership owned by the cable companies was granted a general license for providing domestic fixed-line telecommunications services, including telephony, data communications and access to internet providers. The partnership is obligated to gradually provide its services nationwide. In November 2004, the partnership commenced providing services under its license on a commercial basis, and in 2005 it stepped up its marketing efforts.

c. On July 5, 2004, regulations were published relating to procedures and conditions for the receipt of a special general license for the provision of domestic fixed-line communications services with no universal service obligation. Under the regulations, the licensee is to be the owner and operator of the telecommunications network by means of which the services are to be provided to its subscribers, but at the same time, the licensee will be entitled to use the infrastructure of others, provided that it is the owner and operator of the switch via which the services are provided to its subscribers. In December 2005, such a license was granted to one operator.

d. On August 1, 2004, a temporary order took effect pursuant to which, for a period of two years or until the creation of a difference of up to 1.05 billion traffic minutes between the Company's network and the network of another domestic fixed-line operator (with the exception of a special licensee and the Company), whichever is the earlier of the two, interconnect fees will not be paid for call completion between networks of such domestic fixed-line operator. The Company receives compensation in respect of non-payment of interconnect fees in the form of a reduction in the royalties paid to the State. This compensation will be up to NIS 40 million.

e. On November 30, 2004, the Ministry of Communications published a policy paper regarding "Licensing the provision of telephony service by means of broadband access (VOB) of a domestic fixed-line operator". On April 20, 2005, the Ministry of Communications notified, *inter alia*, the Company and its subsidiaries, that in the course of the completion of the preparation of the policy and after an examination of the response that had been given in answer to their application, it was considering amending the main policy paper so that the Company or a subsidiary of the Company would be entitled to provide VOB services after the Company's market share in the domestic fixed-line telephony sector in a certain customer segment dropped below 85%. The Company deems such an amendment to be a potential worsening of its situation and that of its subsidiaries, and it submitted its objection to the policy paper to the Ministry of Communications. The Company clarified, *inter alia*, that Bezeq should not be denied the possibility of providing VOB services, and such a denial would be in contravention of the license and the law, it would be unprecedented around the world and it would severely damage the Group and its customers.

   As at the date of publication of these reports, the marketing trial license granted to Bezeq International was extended to provide the service until the end of August 2006, and the Ministry of Communications published a notice stating the Bezeq International would be able to provide VOB services on restrictive terms. Pelephone Communications Ltd. also received a marketing trial license.

NOTE 1 – GENERAL (CONTD.)

E. (CONTD.)

(1) Domestic fixed-line communication services (contd.)

f. On March 29, 2005, the Economic Policy for Financial Year 2005 Law (Legislative amendments), 5765-2004 was passed, which includes, *inter alia*, an amendment to the Communications Law (Telecommunications and broadcasts), 5742-1982, whereby the Minister of Communications will prepare a numbering plan for number portability with regard to a general licensee (including a special general licensee) for the provision of domestic fixed-line communication services and with regard to a general licensee for the provision of cellular services, and they will receive directions regarding the implementation and operation of the plan by September 1, 2006 (should the Ministers of Communications and Finance learn that a genuine need has arisen therefor, and for special reasons, they may defer by order, with the approval of the Knesset Economic Committee, the implementation and operation of the plan for a period that shall not exceed three months).

On August 22, 2005, a numbering plan was signed by the Ministry of Communications for the registration of number portability.

As the Company noted in its position paper which was sent to the Ministry of Communications, it is not possible to meet the timeframe determined in the law for the application of the plan. In addition, in the Company's opinion, the application of number portability is likely to require the Company to make significant financial investments in changing software versions and hardware in the Company's switching network, to a material extent. Furthermore, large financial investments will be required in the area of the Company's information systems, which could also cause a deferment of the Company's development plan in this field. In addition, the operation of number portability involves costs in respect of joint records and management with the relevant operators. These are costs whose full scope cannot yet be estimated. In addition to the aforesaid expected costs, the implementation of number portability, which is expected to facilitate customer transfer between the networks of competing communications operators, could have an adverse effect on the way the Company deals with the competition as well as on the other companies of the Group.

The Company and other communications operators have requested postponement of the date for implementation of the plan. The postponement has not yet been approved.

g. On April 10, 2005, the Company received a copy of a letter by the Director-General of the Ministry of Communications, dated April 6, 2005, addressed to the Director of the Government Companies Authority, regarding clarifications to the participants in the proceeding for the privatization of the Company. Pursuant to that stated in the document, it includes clarifications of the main issues that were raised by the participants who took part in the privatization proceeding, clarifications which were given based on the Ministry of Communications' current policy to promote competition in the communications sector and the provisions of the law and the existing licenses, and they should not be deemed to be a basis for an expectation or reliance of any kind by the participants.The clarifications address, *inter alia*, the following issues: the licensing policy for the provision of telephony services by means of broadband access (VOB), the Company's tariffs and volume discounts, baskets of services, payments for interconnect services, royalties, a structural separation, universal service, the Telecommunications Order, use by the subsidiary, DBS, of ADSL for the purpose of the provision of its services, a minimum payment for the creation of a cellular call, the convergence of fixed-line and cellular services and number portability. In the Company's opinion, the clarifications contained in the document of the Director-General of the Ministry of Communications do not significantly reduce the regulatory uncertainty in which the Group and the Company are operating. In addition, the clarifications concern, in general, future actions, which the Company is unable to assess, if and when they will occur, and therefore the Company is also unable to assess their implications on the operations of the Company and the subsidiaries in the Group and or their financial results.

NOTE 1 – GENERAL (CONTD.)

E. (CONTD.)

(1) Domestic fixed-line communication services (contd.)

g. (Contd.)
In addition, the Company believes that no progress has been made on several issues on which the Ministry of Communications gave notice, in an explanatory document of their investigation, and it notified the Ministry that these delays are making it difficult for the Company to prepare for intensifying competition.

(2) Cellular services

a. On December 14, 2005, the Minister of Communications announced his decision obligating the Company to transfer interconnect fees to Cellcom according to the report on the volume of traffic which actually passed from the Company's network to Cellcom's, irrespective of the amounts collected and without deducting a collection commission, and with a deduction of 1.1% relating to the period from March 1, 2000 to October 1, 2000. The Company's financial statements include a provision for the effects of the Minister's decision which the Company believes to be appropriate.

b. On December 5, 2004, the Minister of Communications notified Pelephone and the Company that as part of a process of re-examination of interconnect fees for a cellular network, the Ministry of Communications had decided to amend the Communications Regulations (Telecommunications and broadcasts) (Payments for interconnect), 5760-2000 ("the Interconnect Regulations") ("the Regulations") in a way that will reduce the interconnect fees to a cellular network for call completion, SMS messages and the computation of the duration to be charged.

The main amendments are:
(1) Reduction of payments receivable from a domestic operator or a cellular operator for the completion of one traffic minute on a cellular network from 45 agorot per traffic minute to a maximum tariff of 32 agorot, as from March 1, 2005, to a maximum tariff of 29 agorot as from March 1, 2006, to a maximum tariff of 26 agorot as from March 1, 2007 and a maximum tariff of 22 agorot as from March 1, 2008.
(2) Reduction of payments receivable from an international licensee for completion of a traffic minute on a cellular network from 25 agorot per minute to a maximum tariff of 22 agorot per minute, as from March 1, 2008.
(3) Reduction of payments receivable from a cellular operator for the transfer of an SMS message in a cellular network from 28.5 agorot per traffic minute to a maximum tariff of 5 agorot per minute as from March 1, 2005 and 2.5 agorot per minute as from March 1, 2006.
(4) From March 1, 2006, an annual updating mechanism will be introduced for call completion and SMS tariffs in a cellular network, whereby the tariffs will be updated once a year according to the rate of change in the CPI.
(5) For counting the traffic minutes for computation of the payment for call completion to a cellular network, from January 1, 2009, billing will be according to segments of one second, rather than 12 seconds as is the practice today.

NOTE 1 – GENERAL (CONTD.)

E. (CONTD.)

(3) International communication services

On April 22, 2004, the Communications Regulations (Telecommunications and broadcasts) (Procedures and conditions for receipt of a general license to provide international telecommunication services), 5764-2004, came into effect. Pursuant to these Regulations, the Ministry of Communications has granted general licenses to provide international telecommunication services to three additional operating companies, all of which had commenced operation by the end of 2004 (so that in all, six operators are now active). The broadening of competition has led to a further lowering of international call prices, although unlike when competition started in 1997, the volume of international traffic has not increased significantly as a result, since in the period prior to the broadening of the competition, the cost of the calls was not a factor that deterred the public from using the service. In addition, the broadening of the competition had an adverse effect on the results of operations of Bezeq International in the international call sector, however, since prices and market shares of international calls have not yet finally stabilized, as at the date of publication of these financial statements, Bezeq International and the Company are unable to estimate, at this stage, the extent of the overall effect of the broadening of competition in the field.

The increasing competition and the entirety of the changes in the communications market as described above, are expected to have an adverse effect on the business results of the Group. That effect cannot be assessed.

F. On May 10, 2005, Ap.Sb.Ar. Holdings Ltd. ("Ap.Sb.Ar.") was selected as the preferred bidder in the off-market proceeding for the sale of 781,513,683 shares of the Company held by the State (which constitute approximately 30% of the Company's shares) and options to purchase 277,697,862 shares of the Company held by the State (which constitute approximately 10.66% of the Company's shares) in accordance with the terms set forth in the sale agreement ("the State's Holdings").

On October 11, 2005, the process of transfer of the State's Holdings to Ap.Sb.Ar. was completed, for a sum of approximately NIS 4,246 million. The shares of Ap.Sb.Ar. in the Company are being held in trust by Romema Holdings Co. Ltd.

As a result of the completion of the transaction and the grant of approval for control of the Company to be transferred to Ap.Sb.Ar. in accordance with the Communications Law, the Company was released from certain restrictions which had been imposed on it as a company controlled by the State of Israel, including the cancellation and/or modification of part of the provisions of its Articles of Association, which are similar to certain provisions in the Government Companies Law, 5735 – 1975. In addition, lenders, whose balance of the loan amounts to approximately NIS 344 million, are entitled to declare the bonds which they hold to be immediately due and payable. The bonds were classified in the Company's balance sheet as short-term liabilities (see also Note 14C).

As the Company was informed, in accordance with the agreement between the State and Ap.Sb.Ar., Ap.Sb.Ar. may request that the State vote together with it (as per the restrictions set forth in the agreement with regard to certain matters) in respect of 10.66% of the Company's shares which are held by the State and which Ap.Sb.Ar. received an option to purchase, and in respect of 1.01% of the Company's shares which will remain in the State's possession in the period commencing on October 11, 2005 (the transaction completion date) and ending at the end of the option exercise period, and in respect of 4.71% of the Company's shares held by the State, which are designated for allotment as described below – for the aforesaid period or until the transfer of ownership of these shares to the Company's employees, whichever is the earlier of the two.

NOTE 1 – GENERAL (CONTD.)

G. Pursuant to an offer for sale and public offering pursuant to the Company's prospectus dated May 24, 2004, and the closing of the sale of the controlling interest in the Company in October 2005, the Company's employees are entitled to compensation by means of an allotment of 4.71% of the shares of the Company held by the State. The share allotment will be made by way of a stock options plan pursuant to the description published by the Company on November 15, 2005, as follows:

(1) The Offered Securities

a. Up to 122,697,648 options registered by name, each of which may be exercised into one ordinary share of NIS 1 par value each of the Company (subject to adjustments).

b. The options will not be listed for trading on the stock exchange. The ordinary (registered) shares of NIS 1 par value each which are designated for allotment against the exercise of the options are listed for trading on the stock exchange.

(2) Proceeds of the Securities and the Exercise Price

a. The options are being offered to eligible employees, including a group of former employees ("Offerees") without consideration.

b. The exercise price of each of the options will be NIS 4.037 ("the Exercise Price").
It should be noted that the Exercise Price reflects a weighted price according to 20% of the Company's share price in the public offering according to the prospectus (NIS 5.0239, adjusted to the Consumer Price Index of September 2005) and 80% of the average share price on the stock exchange in the 30 trading days preceding the completion date (NIS 5.9531) less a 30% discount.

The Exercise Price will be linked to the Consumer Price Index (without interest being added) and with adjustments for the distribution of dividends by the Company and for the issue of bonus shares and for the bonus element in the rights issue.

(3) Exercise of the Options

Commencing January 1, 2008, each of the Offerees will be entitled to exercise one-third of the options offered to him ("the First Portion") and to submit an exercise notice, as defined below – subject to the provisions of section 102 – at any time from this date to the expiration of four years and twenty business days from the determining date. At the end of the third year from the determining date, the Offeree will be entitled to exercise an additional third of the total number of options ("the Second Portion"). The Offeree will be entitled to submit an exercise notice, as defined below, for the options included in the Second Portion – subject to the provisions of section 102 – at any time from the expiration of three years from the determining date to the expiration of four years and twenty business days from the determining date.

At the expiration of four years from the determining date, the Offeree will be entitled to exercise an additional third of the total number of options ("the Third Portion"). The Offeree will be entitled to submit an exercise notice, as defined below, for the options included in the Third Portion – subject to the provisions of section 102 – not later than at the expiration of four years and twenty business days. Should the Offeree fail to exercise options pursuant to his entitlement in a particular portion, the options will be added to the next portion.

NOTE 1 – GENERAL (CONTD.)

G. (CONTD.)

(3) (contd.)

The estimated fair value of each option for a share, calculated according to the share price as at September 30, 2005, is NIS 1.49. This estimate was calculated by applying the Black-Scholes-Merton formula for the pricing of options, less a discount at a rate of 25% due to a lack of marketability. The formula includes a standard deviation at a rate of 27%, based on the historical fluctuations of the share and a risk-free interest rate of 2.9%. The total bonus value in the plan is approximately NIS 183 million.

Standard No. 24 of the Israeli Accounting Standards Board - "Share-Based Payment" took effect on January 1, 2006. The Company completed the allotment before that date and therefore this Standard, including its transition provisions, does not apply to the said allotment. Accordingly, expenses in respect of the bonus element contained in the allotment were not be included in the financial statements. The tax benefit to which the Company is entitled will be recorded under a capital reserve, on the date on which the expense is recognized.

H. On March 1, 2006, the Board of Directors of the Company resolved to recommend to the General Meeting of its shareholders the distribution of a cash dividend to the shareholders in the amount of NIS 1,200 million (out of retained earnings accumulated in 2004 and 2005), which as at the date of distribution constitutes NIS 0.46 per share and approximately 46% of the Company's issued and paid up capital. The Board of Directors has called a Special General Meeting of the shareholders of the Company, the agenda of which includes approval of distribution of a dividend to the shareholders as detailed above.

Pursuant to a resolution of the Board of Directors on March 1, 2006, resolutions concerning the distribution of a dividend will be passed specifically according to the financial results of the Company, its financial condition and other relevant circumstances and data. This resolution supersedes earlier resolutions on the matter of dividend policy.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY

A. DEFINITIONS

In these financial statements –

(1) the Company – Bezeq, The Israel Telecommunication Corp. Limited.

(2) the Group - Bezeq, The Israel Telecommunication Corp. Limited and its investee companies, as listed in Appendix A – List of Group Companies.

(3) Subsidiaries – Companies, including a partnership or joint venture, whose financial statements are fully consolidated, directly or indirectly, with the financial statements of the Company.

(4) Proportionately consolidated companies – Companies, including a partnership or joint venture, whose financial statements are partially (proportionately) consolidated, directly or indirectly, with the financial statements of the Company.

(5) Affiliated companies – Companies other than subsidiaries or proportionately consolidated companies and including a partnership, in which the Company’s investment is stated, directly or indirectly, on the equity basis.

(6) Investee companies – Subsidiaries, proportionately consolidated companies or affiliated companies.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY CONTD.)

A. DEFINITIONS (CONTD.)

(7) Investments in venture capital funds – Investment in a fund in which two conditions obtain:
  a. The principal business of the fund is research, development or marketing of innovative and high-tech products or processes;
  b. The source of at least 90% of the fund's financing is shareholder capital (including shareholder loans and credit guaranteed by the shareholders), with the support of State authorities or research grants.

(8) Related parties – As defined in Opinion No. 29 of the Institute of Certified Public Accountants in Israel ("ICPAI").

(9) Interested parties – As defined in Paragraph (1) of the definition of an "Interested Party" in a corporation, in Section 1 of the Securities Law.

(10) Controlling shareholder – As defined in the Securities Regulations (Presentation of transactions between a company and its controlling shareholder in financial statements), 5756-1996.

(11) CPI – The Consumer Price Index published by the Central Bureau for Statistics.

(12) Adjusted value – A nominal historical amount adjusted in accordance with the provisions of Opinions 23, 34 and Opinions 36, 37 and 50.

(13) Reported value – An amount adjusted for inflation to the transition date (December 31, 2003), with the addition of amounts in nominal values added after the transition, and less amounts deducted after the transition date.

(14) Adjusted financial reporting – Financial reporting based on the provisions of Opinions 23, 34, 36, 37 and 50.

(15) Nominal financial reporting – Financial reporting based on reported amounts.

B. FINANCIAL STATEMENTS IN REPORTED AMOUNTS

(1) In October 2001, the Israeli Accounting Standards Board ("IASB") published Accounting Standard No. 12 – "Discontinuance of Adjustment of Financial Statements". Pursuant to this Standard, and Accounting Standard No. 17 published in December 2002, the adjustment of financial statements for inflation was discontinued from January 1, 2004. Until December 31, 2003, the Company continued to prepare adjusted statements in accordance with Opinion 36 of the ICPAI. From January 1, 2004, the Company applies the provisions of the Standard and accordingly, adjustment has been discontinued.

(2) In the past, the Company prepared its financial statements on the basis of historical cost adjusted for the CPI. The adjusted values included in the financial statements as at December 31, 2003 served as the starting point for nominal financial reporting which commenced on January 1, 2004. Additions made during the period were included in nominal values.

(3) Values in respect of non–monetary assets do not necessarily represent market value or an up-to-date economic value, but rather, the reported values of those assets.

(4) In the financial statements, "cost" means cost at the reported value.

(5) All comparative data for prior periods up to January 1, 2004, are stated adjusted to the CPI of December 2003.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

C. REPORTING PRINCIPLES

(1) Balance sheets

a. Non-monetary items are stated at reported values.

b. Monetary items are stated in the balance sheet at historical nominal values as at the balance sheet date.

c. Equity of investments in investee companies is based on the reported financial statements of those companies.

(2) Statements of operations

a. Revenues and expenses deriving from non-monetary items or from provisions included in the balance sheet are derived from the difference between the reported value opening balance and the reported value closing balance.

b. The remaining items of the statement of operations are stated at nominal values.

c. The Company's share in the operating results of investee companies and the share of the rights of the outside shareholders in the results of the subsidiaries are based on the reported financial statements of those companies.

(3) Data of the Company in historical nominal values for tax purposes are given in Note 30.

D. CONSOLIDATION OF FINANCIAL STATEMENTS

(1) The consolidated financial statements include the financial statements of the Company and the financial statements of those companies over which the Company has control. Jointly controlled companies are consolidated in the financial statements by the proportionate consolidation method.

(2) A list of the companies whose reports are included in the consolidated financial statements, the percentage of the holding in shares which grant voting rights and the percentage of the holding in shares granting a share in profits, is presented in Appendix A to the financial statements. In addition, a list of companies of the Corporation which were not consolidated is also presented in Appendix A to the financial statements.

(3) For the purpose of the consolidation, the amounts included in the financial statements of the companies that were consolidated were taken into account after the adjustments necessary in order to apply uniform accounting principles used by the Group.

(4) a. The excess cost of the investment over the fair value of its identified assets less the fair value of the identified liabilities (after allocation of taxes deriving from temporary differences) at the acquisition date, is recorded as goodwill.

b. The excess cost allocated to assets and liabilities is recorded under the appropriate items in the balance sheet.

(5) The Company applies Accounting Standard No. 20 concerning the period of amortization of goodwill. Goodwill is stated in the consolidated balance sheet under "Other assets and deferred charges" and is systematically amortized over its useful life. The amortization period reflects the best estimate of the period in which the Company can expect to derive future economic benefits from the goodwill.

(6) Material inter-company balances between the consolidated companies were eliminated. Earnings from inter-company sales not yet realized outside the Group, were also eliminated.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

D. CONSOLIDATION OF FINANCIAL STATEMENTS (CONTD.)

(7) a. The consolidated financial statements include the proportional part of the items of the assets, liabilities, expenses and revenues of the proportionately consolidated companies according to the percentage of the holding in those companies.

b. Earnings from the sales of the holding company to proportionately consolidated companies not yet realized outside the Group – were eliminated at a rate proportional to the holding.

c. Earnings from the sales of the proportionately consolidated companies to the holding company, not yet realized outside the Group – were eliminated at the full share of the earnings relating to the holding company.

E. USE OF ESTIMATES

Preparation of the financial statements in conformity with generally accepted accounting principles requires Management to make estimates and assumptions which affect the reported amounts of assets and liabilities and of contingent assets and liabilities disclosed in the financial statements, as well as amounts of revenues and expenses for the reporting period. Actual results may differ from these estimates.

F. CASH AND CASH EQUIVALENTS

Cash and cash equivalents include short-term bank deposits and marketable government bonds with an original maturity at the time of making the investment that did not exceed three months.

G. SECURITIES

(1) Marketable securities
Marketable securities held as a current investment are stated at the realizable value on the stock exchange at the balance sheet date. The changes in the values of securities are charged to the statement of operations in full. Marketable securities held as a permanent investment are stated at cost (regarding debentures – including accrued interest and linkage differentials and amortized premium and discount), less a provision for reduction in value of a non-temporary nature (see also section G(3) below).

(2) Non-marketable securities
Non-marketable securities are stated at cost (regarding debentures – including accrued interest and linkage differentials and amortized premium and discount) which, in the opinion of Management, does not exceed the realizable value (see also section G(3) below).

(3) Decrease in value of investments
The Company periodically checks to see whether a non-temporary decrease has occurred in the value of its permanent investments. The review is carried out upon the existence of signs indicating that the value of permanent investments might have been impaired, including falling market prices, the business of the investee, the sector in which the investee operates and other parameters. The deductions for adjusting the value of these investments, which in Management’s opinion are based on examination of all the relevant aspects and giving them their proper weight, and which are not of a temporary nature, are recorded in the statement of operations.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

H. PROVISION FOR DOUBTFUL DEBTS

The financial statements include specific provisions for doubtful debts which, in the opinion of Management, properly reflect the loss inherent in debts, the collection of which is considered doubtful. In determining whether the provisions are appropriate, Management considered, among other matters, the assessment of risk concerning the financial situation of the debtors as derived from the information in its possession, the scope of their operations, the collateral they provided and the accumulated experience of the Company and its external lawyers who handle the collection of past debts. Doubtful debts which Management and its legal advisers believe cannot be collected are written off in the Company's books following a Management decision. Advance payment transactions with credit companies for transactions made with customers by credit card for payment in installments, where the risk of collection was transferred in full to the credit companies, are removed in full from the books. The financial statements also include a general provision in respect of doubtful debts.

I. INVENTORY

Inventory of subscriber equipment and user equipment is stated at the lower of cost or value to the business, where the cost is determined by the moving average method.

As part of its current operations, Pelephone upgrades user equipment for its customers. As a result, inventory includes user equipment returned from customers. The value of the returned inventory is stated at the lower of cost or value to the business. Inventory also includes spare parts which are used by Pelephone, *inter alia*, for the repair of user equipment as part of the repair service it provides for its customers.

J. MATERIALS AND SPARE PARTS

Materials and spare parts are valued at the lower of cost (which is determined by the moving average method) or value to the business. Materials are intended primarily for installation in fixed assets. The Company customarily reduces the value of slow moving materials and spare parts purchased in previous years.

K. INVESTMENTS IN AFFILIATED COMPANIES

(1) Investments in affiliates are accounted for by the equity method. In determining the equity of the investments in these companies, the amounts as they are included in the financial statements of the companies, after adjustments necessitated by the application of accepted accounting principles, are taken into account.

(2) Regarding goodwill amortization policy – see D(5) above.

L. IMPAIRMENT OF INVESTMENTS IN INVESTEE AND NON–INVESTEE COMPANIES

Regarding impairment of investments in investee and non-investee companies, see G(3) above and BB below.

M. COMPANY INVESTMENT IN VENTURE CAPITAL FUNDS

(1) The Company's holdings in venture capital funds are stated at adjusted cost less a provision for impairment, if a decrease in value occurs which is not of a temporary nature.

(2) See also G(3) above.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

N. FIXED ASSETS

(1) Fixed assets are stated at cost.

(2) The cost of an asset which the Company is constructing for itself includes materials, subcontractors, wages and financing expenses in the construction period, but not exceeding their recoverable amount.

(3) Improvements and enhancements are charged to the cost of assets, while maintenance and repairs are charged to the statement of operations as incurred.

(4) In the event of a decrease in the value of the assets to the business, a provision is recorded accordingly. Regarding provision for the impairment of assets, see section BB below.

(5) Real financing expense for loans and credit used for financing the construction or purchase of fixed assets and other costs relating to the purchase or construction of the fixed assets, are charged to the cost of those assets in accordance with Accounting Standard No. 3 – Capitalization of Credit Costs. (See also U below).

(6) Depreciation is calculated by the straight-line method, based on the estimated useful lives of the assets.

Annual depreciation rates:

	% depreciation	% principal depreciation
Buildings	4	4
Digital switching equipment	5-20	10
Transmission and power equipment	10-20	20
Network equipment	5-20	5
Subscriber equipment and public telephones	20	20
Motor vehicles	15	15
Internet equipment	25	25
Office equipment	10-20	10
Computers	20-33	33
Cellular telephone infrastructure equipment	10-20	20

Improvements to leased premises are amortized over the term of the lease (including the Company's option to extend the lease period), which does not exceed the economic life of the asset.

(7) On change of estimate, see Note 9(G).

O. DEFERRED CHARGES AND OTHER ASSETS

(1) Costs of issue of debentures and raising loans
Costs of issue of debentures and raising loans (treated as a non–monetary item) are amortized over the term of the debentures, pro rata to the balance of the debentures in circulation.

(2) Cost of subscriber acquisition
Since 1999, Pelephone has been deferring and recording as an asset its net direct costs paid to a third party ("subscriber acquisition") in respect of a sale to subscribers who signed an undertaking to remain customers of Pelephone. Violation of the undertaking leads to payment of a penalty by the customer and the immediate charging of the amortization of the asset to the statement of operations. These costs are amortized over the period of the subscribers' undertaking, which is up to 36 months.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

O. DEFERRED CHARGES AND OTHER ASSETS (CONTD.)

(3) Frequencies
Regarding Pelephone's investment in cellular communication frequencies in third generation technology, see Note 8D(2).

P. DEFERRED TAXES

(1) In July 2004, the Israeli Accounting Standards Board ("IASB") published Accounting Standard No. 19 – "Taxes on Income" ("the Standard"). The new Standard applies to financial statements for periods commencing on January 1, 2005. Adoption of the Standard will be implemented by way of a cumulative effect of change in accounting method. The transition to Accounting Standard No. 19 amounted to a one-time effect on the profit, in the amount of NIS 15,000,000, which is mainly attributable to an increase in deferred tax assets in respect of buildings and land.

(2) The Group companies allocate taxes in respect of temporary differences. Temporary differences are differences between the value of assets and liabilities for tax purposes and their book value. Deferred tax balances (asset or liability) are calculated according to the tax rates which will be in effect at the time of utilization of the deferred taxes, or upon realization of tax benefits, based on the tax rates and tax laws enacted or the legislation of which is all but completed by the balance sheet date.

The main factors for which deferred taxes were not calculated are as follows:

a. A temporary difference generated at the time of first recognition of goodwill.

b. A temporary difference generated at the time of initial recognition of an asset or liability in a transaction which is not a business combination and on the date of first recognition, there is no effect on either accounting income or taxable income (loss for tax purposes).

c. Investments in investee companies, where the Company intends to continue to hold these investments, and not to realize them.

d. A tax benefit receivable in respect of temporary differences, where the likelihood of realizing the benefit is in doubt.

(3) The tax benefits in respect of grants of capital instruments to employees, in respect of which no expense was recognized, will be recorded under shareholders' equity in the period in which the deduction will be permitted for tax purposes.

Q. CLASSIFICATION OF PROFIT AND LOSS ITEMS

Profit and loss items were classified and stated in the order dictated by the character of the Company's business as a communications company.

R. REVENUE RECOGNITION

(1) Sales of products

Revenue from product sales are recorded at the time of dispatch to the customer, on transfer of the main risks and rewards involved in the ownership of the products being sold.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

(2) Revenue from service

Revenue from service is charged proportionally over the term of the agreement, or upon provision of the service if the probability of the flow of the economic benefit attributed to providing the service is certain.

(3) Sales on credit

Sales on long-term credit (more than a year) are recorded at the present value, where the interest which serves for capitalization is at market rate on the date of the sale.

(4) Revenues from the development of communications infrastructure are charged upon completion of the work.

(5) A consolidated company, D.B.S. Satellite Services (1998) Ltd. ("DBS"), leases digital satellite decoders to its customers under operational leases. The revenues from the lease fees are charged proportionally over the term of the lease agreement.

(6) DBS collects deposits from its customers in respect of the digital satellite decoders at the customer's premises, in an amount that does not exceed the cost of the set top boxes, where, upon termination of the agreement with DBS, the customers are entitled to the proportional part which remains of the deposit, in accordance with the agreement with them. The revenues from amortization of the deposits are charged to the statement of operations in accordance with the terms of the agreement with the customers (for a period of five or ten years).

(7) The Company does not include in the cellular revenues/expenses items the revenues/expenses from interconnect fees from the cellular operators; rather, they are recorded net in accordance with the tests prescribed in Clarification 8 to Standard 25, since the Company's tariffs (including interconnect fees) are set by the State in regulations. In 2005, these interconnect fees amounted to approximately NIS 1.2 billion (2004 – approximately NIS 1.5 billion, 2003 – approximately NIS 1.6 billion). Interconnect fees at Pelephone, using the same tests, are recorded gross.

S. ADVERTISING EXPENSES

Advertising expenses are charged to the statement of operations as incurred.

T. SUPPLIER DISCOUNTS

Current discounts from suppliers are included in the financial statements as received.

Discounts received from suppliers at the end of the year, for which the Company is not required to meet certain targets, are included in the financial statements upon making the proportional purchases that entitle the Company to those discounts.

U. CAPITALIZATION OF CREDIT COSTS

The Company capitalizes credit costs in accordance with Accounting Standard No. 3 – Capitalization of Credit Costs, which requires the capitalization of specific and non-specific credit costs to qualified assets, as defined in the Standard. Non-specific credit costs are capitalized to the investment or part thereof which was not financed by specific credit, at a rate which is the weighted average of the cost in respect of those credit resources whose cost was not specifically capitalized. See Note 9A.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

V. EARNINGS PER SHARE

Earnings (loss) per share are calculated in accordance with Opinion No. 55 of the ICPAI.

W. SOFTWARE DEVELOPMENT COSTS

The costs of software development for internal use are treated according to the position paper of the American Institute of Certified Public Accountants – SOP 98-1: Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. The costs of software development for internal use are capitalized after completion of the preliminary design stage, the project is expected to be completed and the software will be used for its designated purpose. The capitalization is halted when the software is effectively complete and ready for its designated use. Capitalized software development costs are amortized by the straight-line method according to the estimated useful life of the software. Significant improvements to the software are also capitalized to the cost of the software and current maintenance costs are recorded in the statement of operations.

X. FOREIGN CURRENCY AND LINKAGE

Assets (excluding securities) and liabilities denominated in or linked to a foreign currency are stated at the representative exchange rates published by the Bank of Israel on the balance sheet date.
Assets (excluding securities) and liabilities linked to the CPI are stated on the basis of the linkage terms of each balance.

X. FOREIGN CURRENCY AND LINKAGE (CONTD.)

Details of the CPI and foreign currency exchange rates are as follows:

	Consumer Price Index	Exchange rate of the US dollar	Exchange rate of the euro	Consumer Price Index	Exchange rate of the US dollar	Exchange rate of the euro
				%	%	%
Year ended December 31, 2005	**103.0**	**4.603**	**5.466**	**2.386**	**6.848**	**(7.334)**
Year ended December 31, 2004	100.6	4.308	5.877	1.207	(1.621)	6.217
Year ended December 31, 2003	99.4	4.379	5.533	(1.848)	(7.557)	11.350

Y. DERIVATIVES

(1) The results of derivatives held for hedging of existing assets and liabilities are charged to the statement of operations in parallel with the accounting treatment of the results of the hedged assets and liabilities.

(2) Derivatives not designated for hedging are stated in the balance sheet at their fair value. Changes in the fair value are charged to the financing item in the statement of operations in the period in which they occurred.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

Z. BROADCASTING RIGHTS

Broadcasting rights in a consolidated company are stated at cost, less the rights that were exercised. Costs of broadcasting rights acquired for the screening of films and television programs include the amounts of contracts with suppliers of the rights, with the addition of direct costs incurred in order to adapt said films and programs for screening in Israel. Broadcasting rights are amortized in accordance with the terms of their acquisition agreement, based on actual screening (the portion not amortized by the end of the term of the agreement being fully amortized upon termination), or in accordance with the term of the rights agreement. The costs of independent productions which, in the opinion of the consolidated company, can be broadcast a number of times or sold, are charged to the broadcasting rights and amortized on the basis of the estimated duration of their utilization.

AA. SEGMENTAL REPORTING

Segmental reporting is stated in accordance with Accounting Standard No. 11. See also Note 26.

BB. IMPAIRMENT OF ASSETS

The Group companies apply Accounting Standard No. 15 – Impairment of Assets ("the Standard"), which defines procedures which the Company must apply in order to ensure that its assets in the consolidated balance sheet are not stated in an amount exceeding their recoverable amount, which is the higher of net selling prices and usage value (the present value of the estimated future cash flows expected to derive from the use and disposal of the asset).

The Standard applies to all the assets in the consolidated balance sheet except inventory, tax assets and monetary assets (excluding monetary assets which are investments in investee companies that are not subsidiaries). The Standard also lays down the rules of presentation and disclosure for assets whose value has been impaired. Where the value of an asset in the consolidated balance sheet exceeds its recoverable amount, the Company recognizes a loss from impairment in the amount of the difference between the book value of the asset and its recoverable amount. The loss so recognized will be cancelled only if changes occur in the estimates that were used to determine the recoverable amount of the asset, from the date on which the last loss from impairment was recognized.

In September 2003, the IASB published Clarification No. 1 concerning the accounting treatment of an impairment of an investment in an investee company which is not a subsidiary ("the Clarification"). The Clarification states that in the reporting periods subsequent to the period in which the provision for impairment was first created in respect of an investee company which is not a subsidiary, the investment in the investee company should be stated according to the lower of the recoverable amount and the investment account according to the equity method, where the recoverable amount is calculated in each reporting period in which there are indications that a change has occurred in the recoverable amount. Losses from the impairment of an investment in an investee company that is not a subsidiary, which were recognized or cancelled during the period, are included in the Company's equity in the earnings (losses) of investee companies item.

CC. DIVIDEND DECLARED SUBSEQUENT TO BALANCE SHEET DATE

In accordance with Accounting Standard No. 7 – "Post Balance Sheet Events", the liability relating to a dividend proposed or declared subsequent to the balance sheet date is expressed in the accounts only in the period in which the declaration was made. In addition, separate expression is given in the statement of changes in shareholders' equity to the dividend amount to be distributed against a reduction in the retained earnings balance.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

DD. PRESENTATION OF ACTIVITIES BETWEEN A CORPORATION AND ITS CONTROLLING SHAREHOLDER

Transactions between the Company and its controlling shareholder are presented according to the Securities Regulations (Presentation of activities between a corporation and its controlling shareholder) in financial statements), 5756-1996.

EE. DISCLOSURE OF THE EFFECT OF NEW ACCOUNTING STANDARDS IN THE PERIOD PRIOR TO THEIR APPLICATION

(1) In July 2005, the IASB published Accounting Standard No. 22 – "Financial Instruments: Disclosure and Presentation" ("the Standard"). The Standard sets out the rules for the presentation of financial instruments in the financial statements and details the proper disclosure required in respect thereof. In addition, the Standard determines the manner of classification of financial instruments as liability and as shareholders' equity, the classification of interest, dividends, related losses and gains, and the circumstances in which financial assets and financial liabilities should be offset. The new Standard will apply to the financial statements for the periods commencing January 1, 2006 or thereafter. The Standard determines that it should be adopted "from now on".

The comparative amounts stated in the financial statements for periods commencing on the date of the inception of the Standard will not be restated. In the opinion of Company and the other companies of the Group, the application of the Standard is not expected to have a material effect on the results of operations and the financial position of the Company and the other companies in the Group.

(2) In September 2005, the IASB published Accounting Standard No. 24 – "Share-Based Payment". The Standard requires recognition of share-based payment transactions in the financial statements, including transactions with employees or other parties that must be settled in equity instruments, in cash or by other assets. In accordance with the Standard, share-based payment transactions in which goods or services are received will be reported at their fair value.

In addition, the Standard prescribes various disclosure requirements regarding the nature and volume of the share-based payment arrangements that existed during the period, and regarding the manner in which fair value was determined for these arrangements.

The Standard will apply to financial statements for periods commencing on January 1, 2006. Early application is recommended. The provisions of the Standard should be applied to any share-based payment transaction made subsequent to March 15, 2005, and which had not yet vested by the date of inception of the Standard. In addition, the comparative data relating to the periods from March 15, 2005 must be restated.

The application of the new Standard is not expected to have a material effect on the results of operations and the financial position of the Company. With regard to the allotment of shares to employees through an option plan, following the sale of the controlling interest in the Company, see Note 1G. Future plans, if any, will be influenced by application of the Standard.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

EE. DISCLOSURE OF THE EFFECT OF NEW ACCOUNTING STANDARDS IN THE PERIOD PRIOR TO THEIR APPLICATION (CONTD.)

(3) In February 2006, the IASB published Accounting Standard No. 25 – "Income" ("the Standard"). The Standard prescribes the required accounting treatment (rules of recognition, measurement, presentation and disclosure) for income arising from the sale of goods, the provision of services and the use made by others of the entity's assets, which generates income, royalties and dividends. The Standard will apply to financial statements for periods commencing on January 1, 2006 or thereafter. An entity which has not previously stated its income in accordance with the requirements of the Standard, with regard to the reporting of income as gross or net, will apply the provisions of the Standard retroactively with regard to its income for all the reported periods as comparative amounts in the financial statements for the periods commencing on the date of the inception of the Standard. Assets and liabilities included in the financial statements as at December 31, 2005, in amounts which are different from the amounts which would have been recognized had the provisions of the Standard been applied, will be adjusted on January 1, 2006, to the amounts which would have been recognized in accordance with the provisions of this Standard. The effect of the adjustment of the amounts of assets and liabilities, as stated, to January 1, 2006, will be recognized as a cumulative effect of change in accounting method. With the exception of the foregoing, the comparative amounts in the financial statements for the periods commencing on the date of the inception of the Standard will be stated as they were previously stated. The application of the new Standard is not expected to have a material effect on the results of operations and the financial position of the Company and the Group companies.

In February 2006 the IASB published Clarification No. 8 – "Reporting income on a gross basis or a net basis" ("the Clarification"). The Clarification is based on the professional publication EITF 99-19 of the Emerging Issues Task Force in the U.S.A. According to the Clarification, an entity operating as an agency or as a broker without bearing the risks and yields deriving from the transaction, will state its income on a net basis. Conversely, an entity operating as a principal supplier and bearing the risks and yields deriving from the transaction will state its income on a gross basis. The Clarification provides a list of indicators to be considered in order to determine the basis on which income should be reported – gross or net. The Clarification is applicable with respect to financial statements for the period commencing January 1, 2006. Since in the past the Company treated the matter of gross or net income in accordance with the provisions of EITF 99-19, the application of the new Clarification is not expected to influence the Company and the other Group companies in any way.

(4) In February 2006, the IASB published Accounting Standard No. 21 – "Earnings per Share" ("the Standard"). The Standard prescribes that an entity will calculate the amounts of the basic earnings per share with regard to profit or loss, attributed to the ordinary shareholders of the reporting entity, and also that the entity will calculate the amounts of the basic earnings per share with regard to profit or loss from continuing activities, attributed to the ordinary shareholders of the reporting entity, in the event that such earnings are stated. The basic earnings per share will be calculated by dividing the profit or loss which is attributed to the ordinary shareholders of the reporting entity, by the weighted average of the number of ordinary shares in circulation during the period. For the purpose of calculating the diluted earnings per share, an entity will adjust the profit or the loss, which is attributed to the ordinary shareholders of the reporting entity, and the weighted average of the number of ordinary shares in circulation, in respect of the effects of all the diluted potential ordinary shares. The Standard will apply to financial statements relating to periods commencing on January 1, 2006, or thereafter. The provisions of the Standard should be applied retroactively to the comparative data of the earnings per share relating to previous periods. The Company and the other Group companies estimate that the implications of application of the Standard for the first time will have no material effect on earnings (loss) per share.

NOTE 3 – CASH AND CASH EQUIVALENTS

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Israeli currency	**2,055,351**	1,425,433	**1,668,643**	1,322,168
Foreign currency	**103,422**	31,674	**10,601**	5,563
	2,158,773	1,457,107	**1,679,244**	1,327,731

NOTE 4 – SHORT-TERM INVESTMENTS

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Marketable securities:				
Government bonds				
Linked to the CPI	**764,631**	309,701	**698,232**	309,701
Unlinked	**372,075**	465,187	**310,808**	465,187
Linked to the U.S. dollar exchange rate	**1,740**	1,346	**1,740**	1,346
Securities tradable abroad	**242,519**	163,870	**195,086**	163,870
Corporate bonds	**639,923**	128,202	**561,217**	128,202
Short-term loan	**143,547**	41,006	**97,341**	41,006
Shares and options	**63,998**	42,186	**40,869**	42,186
Mutual fund participation certificates	**161,578**	112,827	**135,367**	112,827
Debentures convertible to shares	**5,361**	1,595	**5,241**	1,595
	2,395,372	1,265,920	**2,045,901**	1,265,920
Short-term bank deposits:				
Unlinked bearing interest (Prime less 2%)	**3,153**	21,889	**–**	20,000
	2,398,525	1,287,809	**2,045,901**	1,285,920

On the matter of the management of capital funds raised to finance employee retirement costs, see Note 16D.

NOTE 5 – TRADE RECEIVABLES

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Open accounts	**1,291,522**	1,550,725	**661,965**	732,669
Income receivable	**317,172**	240,912	**189,189**	225,579
Credit cards and checks receivable	**452,551**	458,456	**156,441**	175,696
Investee companies	-	–	**50,721**	33,125
Current maturities of long-term trade receivables (see Note 7)	**391,330**	293,261	**–**	–
	2,452,575	2,543,354	**1,058,316**	1,167,069
Less provision for doubtful accounts	**339,063**	428,284	**161,901**	196,303
	2,113,512	2,115,070	**896,415**	970,766

NOTE 6 – OTHER RECEIVABLES AND DEBIT BALANCES

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Deferred tax asset (see Note 11D)	**194,634**	237,319	**132,198**	159,023
Income tax refundable	**13,160**	7,660	**7,581**	5,570
Prepaid expenses	**93,516**	86,082	**25,254**	22,081
Receivables in respect of derivatives	**4,685**	76,627	**4,685**	76,394
Loan to a consolidated company (See Note 8A(1))	**-**	–	**173,258**	–
Other receivables and debit balances	**15,512**	8,425	**101,427**	107,216
	321,507	416,113	**444,403**	370,284
Including consolidated companies	–	–	**267,273**	99,486

NOTE 7 – INVESTMENTS, DEPOSITS AND DEBIT BALANCES

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Investment in shares – companies that are not investee companies	**8,818**	25,954	**5,253**	22,389
Other investments (1)	**154,111**	301,437	**154,111**	301,437
Bank deposit for granting loans to employees (2)	**193,041**	203,196	**193,041**	203,196
Investment in venture capital funds	**26,335**	19,769	**26,335**	19,769
Long-term loan receivable (CPI + 6.25%)	**22,356**	23,750	**22,356**	23,750
Receivables in respect of derivatives	**1,113**	–	**–**	–
Long-term trade receivables(3)	**361,066**	298,469	**–**	–
	766,840	872,575	**401,096**	570,541

NOTE 7 – INVESTMENTS, DEPOSITS AND DEBIT BALANCES (CONTD.)

(1) Other investments

a. Linkage and interest terms

	Interest rate	Consolidated and Company December 31 2005	Consolidated and Company December 31 2004
		NIS thousands	NIS thousands
Convertible corporate bonds linked to the U.S. dollar	6 month LIBOR + 3.4	**32,221**	30,156
	3 month LIBOR + 1.65	**32,221**	30,156
Investments in fund – euro investments*	–	**32,679**	35,261
CPI-linked investments:			
Capital notes:	5.8 - 5.85	**56,990**	125,988
Galil bonds **	4	**-**	79,876
		154,111	301,437

* In September 2003 the Company invested approximately 6 million euro in a security issued by Deutsche Bank. The security was issued on August 21, 2003 and matures on August 31, 2010. The security is 90% hedged from the investment fund. The yield is contingent on the performance of a solid fund that invests in hedging funds of liquid investments. The security bears no interest.

** In November 2005 the Company's Management announced its intention to sell the bond when market conditions were suitable, and therefore the classification of the bonds was changed to short term investments..

b. Repayment dates

	NIS thousands
2007	**64,442**
2008	**-**
2009	**-**
2010	**32,679**
2011 and thereafter	**56,990**
	154,111

(2) The deposit is unlinked and the average weighted monthly interest rate is approximately 0.33%. The Company is responsible for the loans to the employees. The deposit serves as collateral for the bank to extend loans to Company employees.

NOTE 7 – INVESTMENTS, DEPOSITS AND DEBIT BALANCES (CONTD.)

(3) Long-term receivables

a. Linkage and interest terms

		Consolidated	
		December 31 2005	December 31 2004
	Interest rate	NIS thousands	
Linked to the CPI	7	**720,740**	562,743
Unlinked	7.5-6	**22,700**	20,252
Linked to the U.S. dollar	-	**3,705**	8,735
Unlinked and interest-free	-	**5,251**	-
		752,396	591,730
Less current maturity		**391,330**	293,261
		361,066	298,469

b. Repayment dates

	NIS thousands
2007	**189,059**
2008	**120,740**
2009	**49,557**
2010 and thereafter	**1,710**
	361,066

c. The balance of long-term receivables is stated net of deferred interest income which constitutes the difference between the amount of the original debt and its present value on the day of recognition of the revenue and after deducting a provision for doubtful debts in the amount of NIS 49,237 thousand (for December 31, 2004 – NIS 50,167 thousand).

d. In 2005, Pelephone made forward transactions with credit companies for the final clearance of current debts amounting to NIS 262 million (2004 – NIS 276 million).

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES

A. COMPOSITION:

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Affiliated companies				
Shares – cost	**175,247**	164,006	**100,193**	90,921
Long-term loans (1)	**5,514**	1,386,504	**–**	1,357,861
Post–acquisition losses	**(39,513)**	(1,168,064)	**191**	(1,100,760)
Increase in holding percentage – company consolidated for the first time	**–**	(178,339)	**–**	(180,555)
Provision for impairment in respect of an affiliated company – see Section G below	**(59,196)**	(59,196)	**(38,078)**	(38,078)
Amortization of goodwill	**(6,585)**	(74,603)	**(6,585)**	(74,259)
	75,467	70,308	**55,721**	55,130
Consolidated subsidiaries				
Shares – cost			**1,188,111**	703,046
Loans (1)			**5,607,150**	4,733,726
Increase in holding percentage – company consolidated for the first time and assumption of full control of a proportionally consolidated company			**–**	1,194,844
Post–acquisition losses			**(742,517)**	(161,345)
Provision for impairment			**(4,716)**	(4,716)
Amortization of goodwill			**(157,850)**	(36,209)
			5,890,178	6,429,346
Proportionally consolidated company				
Shares – cost			**–**	485,065
Post-acquisition earnings			**–**	490,080
Increase in holding percentage – acquisition of minority share			**–**	(1,014,289)
Amortization of surplus equity over cost charged to fixed assets			**–**	39,144
			–	–
			5,945,899	6,484,476

(1) Loan balances of Bezeq International to Walla Communications Ltd. (a listed affiliate) (“Walla”) amounting to approximately NIS 5.5 million, linked to the CPI and interest-free. The loans will be repaid on a date soon after the date on which Bezeq International invests in Walla.
Loan balances of approximately NIS 192 million linked to the CPI ("known"), bearing 5.5% annual interest and for which no repayment date has yet been set.
Loan balances of approximately NIS 580 million linked to the CPI ("known"), bearing annual interest of approximately 11%, for which no repayment date has yet been set.
During 2001 Bezeq International received CPI-linked, interest-free loans from the Company of approximately $38 million, the amounts of which as at December 31, 2005 and 2004 are approximately NIS 173 million and NIS 169 million, respectively. On February 1, 2006, after the management of Bezeq International estimated that Bezeq International was able to repay the loans without adverse effect on the management of its current business, the Board of Directors of Bezeq International decided to bring forward the loan repayment date and repay the Company. On February 14, 2006, the CPI-linked amount of the loans was repaid. Accordingly, the balance of the loans as at the balance sheet date is stated as current maturities under the item "other receivables and debit balances.
The loan balances are linked to the CPI ("known"), bear no interest and no repayment date has yet been set.

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

The market value of Walla, a listed company, as at December 31, 2005, is approximately NIS 88.3 million (book value approximately NIS 19.7 million).

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Goodwill not yet fully amortized – consolidated in respect of investee companies	**1,703,918**	1,797,691	**1,699,554**	1,792,658

A list of the companies in the Group appears in an appendix to the financial statements.

B. INVESTMENT ACTIVITY IN 2005 IS AS FOLLOWS:

	Consolidated	Company
	NIS thousands	NIS thousands
Balance as at the beginning of the year	**70,308**	**6,484,476**
Movement during the year:		
Investment in shares	**11,241**	**9,272**
Investment in (repayment of) loans	**6,563**	**(568,145)**
Revaluation in respect of loans	**–**	**83,708**
Equity in losses of affiliates/investee companies	**(12,645)**	**(63,412)**
Balance as at the end of the year	**75,467**	**5,945,899**

C. SUMMARY OF COMPANY EQUITY IN REVENUE AND EXPENSES OF A PROPORTIONATELY CONSOLIDATED COMPANY, AS INCLUDED IN THE CONSOLIDATED STATEMENTS

	For the period ended August 26, 2004*	For the year ended December 31 2003
	NIS thousands	NIS thousands
Revenues	1,658,452	1,899,709
Costs and expenses	1,438,414	1,803,052

* On August 26, 2004, the transaction for exercise of the option to purchase the remaining 50% of the shares of Pelephone was finally closed. Since that date, Pelephone has been wholly owned by the Company. See Note 8D(1).

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

D. PELEPHONE COMMUNICATIONS LTD.

(1) On August 26, 2004, after receipt of approvals from the Ministerial Committee on Privatization, the Minister of Communications and the Antitrust Commissioner for the merger of Bezeq, Pelephone Holdings – a corporation from the Shamrock Group ("Pelephone Holdings") and Pelephone, the transaction for exercise of the option was finally closed when the Company exercised an option to purchase the remaining 50% of Pelephone's shares in consideration of an exercise price of US $60 million (approximately NIS 270 million). In addition, immediately prior to closing the option exercise, Pelephone distributed to its shareholders a dividend of approximately $8.3 million (approximately NIS 38 million). With the closing of the exercise transaction as aforesaid and conversion of the convertible debentures (of a par value of $240 million, stated in the financial statements at zero value), the Company extended a loan of NIS 1,766 million ($394 million) to Pelephone Holdings, which was used for actual clearance of the balance of the loans it had taken from the bank to finance part of the cost of purchasing the Pelephone shares. After the closing of the transaction as aforesaid, the Company recorded NIS 1,045 million of goodwill on the purchase. The amortization period was set at 20 years, which is the expected period of economic benefit.

It is noted that the approval of the Antitrust Commissioner was made contingent upon a number of conditions which in the opinion of the Company restrict business or commercial cooperation between the Company and Pelephone even more than the restriction relating to structural separation that is written into the Company's general license. It is further noted that an appeal filed in the Antitrust Court by Cellcom, petitioning for revocation of the merger approval, was struck out at its request in August 2005.

Towards the end of 2004, Pelephone Holdings transferred all its assets (including Pelephone shares) and liabilities to the Company, and as a result, all Pelephone shares are wholly owned by the Company. Pelephone Holdings is currently in voluntary liquidation.

(2) In December 2001, Pelephone won a tender for an additional band of frequencies which would be used for cellular communications with third generation technology, and Pelephone's license was extended to 2022. The grant of the frequencies was made contingent upon conditions that include, *inter alia*, payment of NIS 225 million (plus Accountant General's interest except for the first payment, which is linked to the CPI) for the new frequency ranges, and provision of a guarantee of $20 million to guarantee the terms of the license, which was amended in 2004 to $10 million. The payment determined at the award was to be paid in six installments on various dates through 2006. On the contract for purchase of the frequencies, see also Note 19B(6).

(3) On February 27, 2006, the Board of Directors of Pelephone resolved to recommend to the General Meeting of the shareholders to distribute a cash dividend in the amount of NIS 300 million on April 14, 2006.

E. D.B.S. SATELLITE SERVICES (1998) LTD.

In January 1999 DBS received a license from the Ministry of Communications for satellite television broadcasts and commenced provision of services in July 2000. Since commencing operations, DBS has accumulated considerable losses. Its losses in 2005, 2004 and 2003 amounted to approximately NIS 328 million, NIS 366 million and NIS 555 million, respectively. As a result of these losses, the capital deficit and working capital deficit of DBS as at December 31, 2005, amount to approximately NIS 3,569 million and NIS 459 million, respectively.

The Company's investment in DBS (mainly shareholders' loans) as at the balance sheet date was approximately NIS 1,562 million (excluding interest and linkage). The Company's equity in the accumulated losses from the date of investment in DBS (excluding amortization of goodwill) is approximately NIS 1,575 million, of which approximately NIS 305 million was recorded during the reporting period (DBS's loss net of the increase in new loans provided by the minority shareholders). The balance of DBS's current debt to the Company and its consolidated companies amounts to approximately NIS 88 million.

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

E. D.B.S. Satellite Services (1998) Ltd. (contd.)

As decided by the Minister of Communications at the end of 2004, injections of financing by the Company to DBS were limited to the following:

(1) The total amount of the planned Additional Funding was limited to a maximum of NIS 350 million (rather than NIS 440 million).

(2) With reference to the NIS 195 million of the Additional Funding already injected by the Company at that time into DBS, no further instruction was given.

(3) The balance of the sum, a maximum of NIS 155 million, will be transferred once every quarter in equal parts during 2005, on the following principles:

a. The Company's share in this amount will not exceed 55% (a maximum of NIS 82.25 million).

b. The share of the other shareholders in DBS and of the banks or institutional bodies in transfer of the remainder of the balance, will be not less than 45% (a minimum of NIS 69.75 million).

In February 2005 the above decision was revised by the then Minister of Communications as follows:

(1) The Company will be able to inject 75% of the maximum amount (NIS 64 million) by the end of June 2005 (i.e. an additional NIS 10 million beyond the amount it had transferred by the date of the letter), provided that up to the end of June 2005 the proportions of the transfer decided upon by the outgoing Minister were fully maintained.

(2) The Company will be able to inject the remainder of the maximum amount (NIS 21.25 million) during the period July 1, 2005, through the end of 2005, provided that the proportions of the transfer are maintained as set out in the Minister's directive.

In the opinion of DBS and the Company, implementation of the directives in the Ministers' notices would cause material harm to both DBS and the Company as the principal shareholder in DBS.

On January 6, 2005, the Board of Directors of the Company resolved that in view of the oppressive conditions upon which the merger of the Company and DBS (increasing the Company's holdings in DBS to more than 50%) had been made contingent by the Antitrust Commissioner ("the Commissioner") (in which, *inter alia*, the Commissioner limited the injection of funds by the Company into DBS so as not to exceed, for a period of nine months from the date of approval of the merger, the proportional part of the Company is DBS's shares, while the other part would be injected by other DBS shareholders and institutional investors), the Company would delay, at that stage, the exercise of the options for shares it received from DBS under the agreements signed between the shareholders of DBS and DBS, so that its holdings in DBS would remain, for the time being, at approximately 49.8%. In respect of injections into DBS as at December 31, 2005, the Company is entitled to shares and/or options for shares which, if exercised, will bring the Company's holdings in DBS to approximately 58.36%.The Company and DBS each filed an appeal against the decision of the Commissioner to permit it to increase the Company's holdings in DBS on conditions. The Company subsequently applied to strike its appeal, *inter alia,* since the term of the condition limiting the Company's injections of funds into DBS was about to end. DBS also filed an application to strike its appeal for the same reasons, and on September 19, 2005, the appeals were stricken.

At the beginning of January 2006, with the elapse of one year since grant of approval for the merger, the approval expired and requires new consent.

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

E. D.B.S. SATELLITE SERVICES (1998) LTD. (CONTD.)

On February 17, 2005, the Board of Directors of the Company resolved that it stands behind its resolution from March 2004 as amended in May 2004, to invest in DBS according to the approved business plan, together with the other shareholders and financial bodies. This resolution was based, *inter alia*, on an external legal opinion stating that the Minister of Communications does not have the authority to prohibit the injection of funds into DBS. On February 23, 2005, the Minister of Communications notified the Company that should it transpire that the Company is taking the law into its own hands and is violating the directive of the Minister, the Ministry of Communications would be compelled to adopt the means of enforcement available to it for ensuring compliance with the terms of the Company's license, including considering calling in the bank guarantee which the Company had deposited as required under its general license. The Company applied to the Jerusalem District Court for a declaratory judgment determining that the decisions of the Ministers of Communications which limited the Company's transfers of funds to DBS were made *ultra vires*, and are therefore void. On March 20, 2005, the District Court ruled that the competent court for hearing the case is the High Court of Justice, and accordingly, it transferred the proceeding to that court. The Company then filed in the Supreme Court, on April 17, 2005, both an application for leave to appeal the decision of the District Court and an application – if its application for leave to appeal was dismissed – to convert the claim into a petition to the High Court of Justice. The application for leave to appeal the District Court's decision was dismissed, and on May 10, 2005 the petition on the matter was filed in the High Court of Justice. It is noted that DBS also filed a petition in the High Court of Justice, to which the cable companies were joined as respondents in the same matter. On October 11, 2005, the High Court of Justice heard the petitions filed by DBS and the Company, contesting the authority of the Minister of Communications to intervene in the transfer of funds to DBS by its shareholders, including the Company and external bodies. The petition raises questions of principle which are far from simple from both the factual and legal aspects, which were brought into focus during hearing. The High Court of Justice has not yet ruled on the petition, and the Company, relying on its legal advisers, is unable to estimate its prospects. It should be noted that concurrently with this proceeding, the Ministry of Communications gave notice of its intention to call in NIS 10 million of the Company's guarantee. On July 7, 2005, the Company, exercising its right under the terms of the general license, filed a petition against the decision of the Ministry to call in the guarantee. See also Note 19C(2).

The terms of the long-term loans which DBS received from certain banks, and the balance of which as at December 31, 2005 is NIS 1,325 million (including current maturities), impose various limitations on DBS, which include, *inter alia*, limitations concerning lien or sale of certain assets, limitations in receipt of credit from other banks without prior approval, a limitation relating to repayment of shareholders' loans and a requirement to meet financial criteria ("the Conditions"). As at December 31, 2005, DBS is in compliance with the Conditions. After grant of benefits to DBS in December 2005 relating to the maximum credit terms (see also Note 13D(2)(e)), that same month the banking corporations increased the credit facility for DBS by NIS 25 million in a document amending the loan agreement signed between them and DBS.

During 2005, DBS signed agreements with three institutional bodies, under which they extended loans to DBS in a total mount of NIS 100 million (including options for loans, which were exercised).

These loans are linked to the CPI and bear 11% interest. They are repayable together with the interest and linkage differentials on December 31, 2013, but can be repaid earlier, subject to repayment of part of the loans to the Banks on the terms set out in the agreement.

The above-mentioned loans do not meet some of the conditions and limitations imposed by Ministers of Communications as explained above and in respect of which the Company and DBS have instituted legal proceedings.

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

E. D.B.S. SATELLITE SERVICES (1998) LTD. (CONTD.)

As explained in Note 19C(10) below, the Company undertook in connection with the above three loans, that if by December 31, 2013, those loans (all or some of them) are not repaid, or under certain other conditions, the lenders will be able to demand that the Company repay the lower of the balance of the loans (principal, interest and linkage differentials) and the amount computed according to a predetermined formula which takes into account the value of DBS at that time.

As at December 31, 2005, the Company had transferred to DBS a total of NIS 284 million out of the Additional Funding.

During 2005 and up to the date of approval of the financial statements, the additional shareholders transferred NIS 29 million to DBS.

On January 31, 2006, the Board of Directors of DBS approved the budget for 2006. According to the budget, in 2006 DBS will require additional external financing. As at the date of approval of the financial statements, DBS is seeking additional sources of finance which will enable it to attain the budgetary targets for the coming year. If no such sources can be found, DBS will operate in accordance with an alternative business plan which does not require additional resources beyond those already assured. The management of DBS believe, based on the 2006 budget and on the alternative business plan, that there is a good chance of arranging the additional financing that it will require in the coming year.

F. WALLA! COMMUNICATIONS LTD.

Bezeq International invested in Walla! Communications Ltd. ("Walla"), an Israeli company which is listed on the Tel Aviv Stock Exchange and which provides internet services and operates internet portals. As at December 31, 2005, Bezeq International held 42.85% of the rights in Walla (at full dilution – 33.94%). Following the exercise of options (Series 3) of Walla after the balance sheet date by others, the Bezeq International's holding in Walla decreased to 40.42% (at full dilution – 33.66%).

Under the investment agreement between Bezeq International and Walla and an undertaking pursuant to a prospectus, Bezeq International had invested in Walla, up to December 31, 2005, by way of investment in shares and grant of loans, a total of approximately NIS 80 million.

G. ADANET FOR BUSINESS GROUP LTD. (IN TEMPORARY LIQUIDATION) ("ADANET")

Adanet is a private company in liquidation proceedings whose business was the installation and servicing of networks and computer equipment. In 2003 the Company wrote off the balance of its investment in Adanet.

In February 2004 the Company received a letter from the temporary liquidator of Adanet and some of the Adanet Group companies, in which it is claimed that the Company had made a commitment to provide the financing required for the current operations of the companies through March 31, 2004, as well as additional financing. In the opinion of the Company, in view of Adanet's situation, the basis for the undertaking made by the Company, if and insofar as made, no longer exists, and therefore it rejected the claim of the liquidator and made no provision in its financial statements. In any case, the Company considers that there is no significant exposure arising from the liquidator's claims.

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

G. ADANET FOR BUSINESS GROUP LTD. (IN TEMPORARY LIQUIDATION) ("ADANET") (CONTD.)

On March 29, 2004, the Court allowed the application of the temporary liquidator, who had meanwhile been appointed special administrator, to investigate the circumstances that led to the collapse of Adanet. On May 17, 2004, the special administrator sent summonses for questioning to five senior employees of the Company who were involved in Adanet's activities (some of them served as directors in Adanet). On January 11, 2006, documents found at the Company in connection with Adanet were submitted to the company's liquidator. It is clarified that the filing of a claim by the liquidator against a third party (including shareholders), is subject to the approval of the court which is overseeing the liquidation proceedings. The liquidator has not yet filed an application on this matter. In the opinion of the Company, relying on its legal advisers, it is difficult at this stage to assess the future steps of the liquidator relating to the possibility that he will seek to file a claim against the Company, to the alleged grounds for the claim and to the prospects for his allegations.

NOTE 9 – FIXED ASSETS

A. COMPOSITION AND ACTIVITY

Consolidated

	Land & buildings	Switching, transmission and power equipment	Network equipment	Subscriber equipment	Motor Vehicles	Office equipment and computers	Total
				NIS thousands			
Cost –							
Balance as at January 1, 2005	2,370,469	14,760,894	11,974,435	2,841,700	190,734	2,173,049	34,311,281
Additions	**48,820**	**624,810**	**182,633**	**425,605**	**4,797**	**300,322**	**1,586,987**
Disposals (1)	**4,873**	**4,931,095**	**24,625**	**147,982**	**46,765**	**115,299**	**5,270,639**
Balance as at December 31, 2005	**2,414,416**	**10,454,609**	**12,132,443**	**3,119,323**	**148,766**	**2,358,072**	**30,627,629**
Accumulated depreciation –							
Balance as at January 1, 2005	1,547,756	9,830,363	9,211,689	1,448,153	135,602	1,272,060	23,445,623
Additions	**107,875**	**1,108,454**	**333,891**	**452,100**	**19,248**	**309,143**	**2,330,711**
Cancellation in respect of disposals (1)	**2,015**	**4,907,163**	**24,625**	**129,344**	**39,789**	**113,741**	**5,216,677**
Balance as at December 31, 2005	**1,653,616**	**6,031,654**	**9,520,955**	**1,770,909**	**115,061**	**1,467,462**	20,559,657
Provision for impairment –							
Balance as at January 1, 2005	2,371	115,467	-	-	66	7,420	125,324
Balance as at December 31, 2005	**2,371**	**115,467**	**-**	**-**	**66**	**7,420**	**125,324**
Net book value –							
As at December 31, 2005	**758,429**	**4,307,488**	**2,611,488**	**1,348,414**	**33,639**	**883,190**	**9,942,648**
As at December 31, 2004	820,342	4,815,064	2,762,746	1,393,547	55,066	893,569	10,740,334

NOTE 9 – FIXED ASSETS (CONTD.)

A. COMPOSITION AND ACTIVITY (CONTD.)

Company

	Land & buildings	Switching, transmission and power equipment	Network equipment	Subscriber equipment	Motor Vehicles	Office equipment and computers	Total
	NIS thousands						
Cost –							
Balance as at January 1, 2005	2,177,286	6,342,750	11,974,435	738,211	110,831	780,570	22,124,083
Additions	**11,121**	**288,797**	**182,633**	**158,988**	**1,323**	**144,928**	**787,790**
Disposals (1)	**3,721**	**1,328,341**	**24,625**	**118,254**	**38,003**	**112,049**	**1,624,993**
Balance as at December 31, 2005	**2,184,686**	**5,303,206**	**12,132,443**	**778,945**	**74,151**	**813,449**	**21,286,880**
Accumulated depreciation -							
Balance as at January 1, 2005	1,440,479	4,469,504	9,211,689	364,731	88,749	383,000	15,958,152
Additions	**86,240**	**630,911**	**333,891**	**173,223**	**8,273**	**157,897**	**1,390,435**
Cancellation in respect of disposals (1)	**1,451**	**1,328,332**	**24,625**	**118,254**	**32,515**	**112,049**	**1,617,226**
Balance as at December 31, 2005	**1,525,268**	**3,772,083**	**9,520,955**	**419,700**	**64,507**	**428,848**	**15,731,361**
Provision for impairment -							
Balance as at January 1, 2005	–	35,482	–	–	–	–	35,482
Balance as at December 31, 2005	**–**	**35,482**	**–**	**–**	**–**	**–**	**35,482**
Net book value –							
As at December 31, 2005	**659,418**	**1,495,641**	**2,611,488**	**359,245**	**9,644**	**384,601**	**5,520,037**
As at December 31, 2004	736,807	1,837,764	2,762,746	373,480	22,082	397,570	6,130,449

(1) Fixed assets are written off the books at the end of the year in which they became fully depreciated, except for land, buildings and vehicles, which are written off the books when sold. In 2005, fully depreciated fixed assets with a cost of approximately NIS 1,583 million in the Company and NIS 5,138 consolidated (2004 – NIS 1,847 million in the Company and consolidated) were written off the books.

(2) The cost includes the amount of NIS 7,797 thousand in the Company and consolidated, which constitute real financing expenses in respect loans and credit which were capitalized during the period of account, calculated at an average real interest rate of approximately 4.8% per annum (prior year – 6.5%).

NOTE 9 – FIXED ASSETS (CONTD.)

B. Most of the real estate assets used by the Company were transferred to it by the State under an agreement dated January 31,1984, and for the consideration detailed therein. Some of these assets are leased for 49 years with an option for an extension for another 49 years, and some are rented for renewable periods of two years each.

On May 15, 2003, a settlement agreement was signed between the Company and the Government of Israel in the name of the State of Israel and the Israel Lands Administration ("the Administration"). The agreement regulates the dispute between them relating to the rights of the Company in various real estate assets which were transferred to the Company when it commenced operations in 1984, under an asset transfer agreement signed between the Company and the State.

C. The Company's holdings in the satellite corporation Intelsat, which was privatized in 2001 when every member of Intelstat became a shareholder proportionate to the percentage of its investment in the corporation, is 0.7405%. In addition, the Company held 0.8% in a subsidiary spun off from Intelsat, called New Skies Satellites N.V. NSS ("NSS").

On November 17, 2004, the Company received approximately NIS 35 million in respect of its share of the proceeds from the sale of the operation, assets and liabilities of NSS. A capital gain in the full amount of the consideration was recorded during 2004.

In addition, on November 17, 2004, notice was received from Intelsat confirming the intention to sell the corporation for a consideration of which the Company's share amounts to approximately NIS 104 million. The sale transaction was closed on January 28, 2005, at its original price. A capital gain in the full amount of the consideration was recorded in 2005.

D. As at December 31, 2005, Pelephone had a commitment to purchase terminal assets during 2006 in a total amount of NIS 353 million.

E. As at the balance sheet date there are agreements to purchase fixed assets amounting to approximately NIS 665 million consolidated and NIS 118 million in the Company (the amounts include the assets referred to in D. above).

F. In September 2003, the Board of Directors of the Company adopted a resolution to close the Inmarsat station (a satellite communications station) and to try to sell the equipment and/or the operation. In view of the uncertainty as to the consideration it would receive, if any, a loss of approximately NIS 35 million due to impairment of assets was recorded in the 2003 financial statements and attributed to fixed assets, which was included under the "Other expenses" item in the statement of operations. The Ministry of Communications notified the Company that it is not authorized to decide on the closure of the station. Consequently, the Company (with the knowledge of the Ministry of Communications) contacted representatives of the Ministry of Defense and the Israel Defense Forces ("IDF") in an attempt to reach an arrangement for termination of the service. IDF representatives stated unequivocally that the Inmarsat service is an essential service that the IDF cannot forgo. In light of this, the Company examined a number of possible actions, including sale of the service (with the consent of the Ministry of Defense, the IDF and the Ministry of Communications), bringing in a strategic partner or continued operation of the service while subsequently significantly reducing its costs. On February 14, 2006, a Memorandum of Understanding was signed between the Company and a foreign investor concerning sale of the satellite operations of the Company (Inmarsat and Bezeq Sat) and associated assets, in consideration of $9 million. The closing of the transaction is subject to the parties signing a final agreement and to internal and external consents and approvals, including of the competent bodies of the parties, the Ministry of Defense, the Ministry of Communications and the Antitrust Commissioner. If the transaction is closed, the Company can expect to record a capital gain of approximately NIS 30 million (before tax).

NOTE 9 – FIXED ASSETS (CONTD.)

G. Depreciation policy

(1) Pursuant to the Company's policy of periodically re-examining the useful lives and the values of its assets, a committee was appointed in 2003 to assess the need to update the period of the useful life and value of the assets and to make recommendations to the Management regarding its conclusions. The examination covered only the Company's fixed assets and was based on the balance of its fixed assets as at December 31, 2003. In interim conclusions relating to the value of the assets, the committee found that due to the decline in traffic in the Company's communications network, mainly as a result of the decrease in the number of subscribers and of the decline in dial-up internet traffic, the Company had ceased using equipment having a net book value of approximately NIS 163 million. As a result, in 2003 an expense was recorded in that amount under the "Other expenses" item in the statement of operations. In May 2004, the panel submitted its recommendations to the Management of the Company regarding the estimated useful life of the assets. The panel's recommendations mainly took into consideration the Company's investment plans, technological innovations in fixed-line communications, rates of depreciation used by similar communications companies around the world as well as the regulation and opening of the fixed-line communications market to competition.

The changes in the estimated useful lives recommended in the report included shortening the life of terminal equipment used for data communications networks from 5 years to 4 years, and shortening the life of new copper cabling from the exchanges to the distribution boxes from 20 years to 15 years. Conversely, it was recommended that the lives of SDH transmission should be extended from 7 years to 8 years, and of the data communications networks (ADSL, ATM) from 5 years to 7 years. The panel also recommended extending the depreciation period of the network in which there was investment until 1991 and which should have been fully depreciated by the end of 2007, through to the end of 2010. Another recommendation was for an estimated useful life for the new transmission systems and data networks which are scheduled for operation in the near future.

The Company's Management and the Board of Directors adopted the recommendations of the panel and the new depreciation rates have been applied since January 1, 2004. As a result of adoption of the recommendations, the depreciation expense in respect of the Company's existing assets decreased by approximately NIS 77 million in 2004, by approximately NIS 74 million in 2005, and in the future will decrease NIS 62 million in 2006, NIS 75 million in 2007 and will increase by NIS 96 million in 2008.

(2) DBS depreciates its digital satellite decoders (set-top boxes – "STBs") using the straight-line method, based on the estimated duration of their use. With the accumulation of experience and data during the course of DBS's operations, during 2004 DBS decided to examine the useful life of the STBs. As part of this examination, DBS received an engineering opinion relating to the useful life of the STBs. According to this opinion, which takes into account, *inter alia*, exposure to technological changes, the useful life of an STB is no less than 6 years, and accordingly, the depreciation rate for STBs was changed from 25% to 17%, effective from April 2004. The change decreased the amount of depreciation in 2004 by approximately NIS 59 million.

H. Bezeq International – provision for impairment, change of estimate and removal of assets in 2003

As part of the preparation of its financial statements for 2003, Bezeq International conducted a comprehensive review of the book value of all its fixed assets, *inter alia* following the coming into force of Standard No. 15 of the IASB - Impairment of Assets and the potential implications of changes in the telecommunications business sector in which Bezeq International operates.

NOTE 9 – FIXED ASSETS (CONTD.)

H. BEZEQ INTERNATIONAL – PROVISION FOR IMPAIRMENT, CHANGE OF ESTIMATE AND REMOVAL OF ASSETS IN 2003 (CONTD.)

Following the comprehensive review mentioned above, expenses derived from fixed assets in an aggregate amount of NIS 146.8 million were recorded in 2003, divided as follows: NIS 89.8 million stated in the "Other expenses, net“ item derived from the depreciation of assets (mainly undersea cables), NIS 21.1 million included mainly in the “Operating expenses” item in the statement of operations for 2003, stated in the "Operating expenses" item, deriving mainly from a change in estimate of the remaining useful economic life of part of Bezeq International’s assets as described below; and NIS 35.9 million stated in the “Other expenses” item derived from the deterioration of assets since they are no longer used. The amount of the reduction according to Standard No. 15 was determined, *inter alia*, on the basis of the assessments of experts and the assessments of the Management of Bezeq International regarding the net sale price, as derived from agreements made by Bezeq International at that time, and the usage value of the assets under review. For the purpose of determining usage value, Bezeq International used, where relevant, a discount rate of 10%.

As part of the comprehensive review of the book value of all its fixed assets which Bezeq International carried out as aforesaid, the Management of Bezeq International examined, with the assistance of external and internal experts in the field, the economic life of its assets, mainly switching equipment and systems, transmission equipment (old-generation undersea cables) and internet equipment. Based on the opinions of these experts, the remaining economic life of the assets examined, at the time of the examination, is shorter than the economic life attributed to them by Bezeq International in the past. On the basis of these opinions, the economic life of switching equipment and systems was shortened by two years (to 10 years); the economic life of the transmission equipment (underwater cables) was estimated mostly at 5-15 years (rather than the 10-20 years estimated prior to submission to Bezeq International of the expert opinion); and the economic life of internet equipment was assessed at 4 years (rather than 12). Consequently, and relying on the aforementioned opinions, starting from the date of the review, Bezeq International is depreciating the balance of the net book value of the assets which were the subject of those opinions, over the stated periods.

The above change of estimate led to an increase of NIS 21.1 million in depreciation expenses for 2003.

The amount of NIS 35.9 million, which derives from assets removed due to termination of their use in 2003, represents their net book value as at the date of their removal, and includes mainly the net book value of NIS 24.7 million of old-generation undersea cables which Bezeq International decided would no longer be operated, and the net book value of improvements to leased premises which Bezeq International had vacated, amounting to NIS 4.6 million.

NOTE 10 – DEFERRED CHARGES AND OTHER ASSETS

Consolidated

			Balance for amortization	
	Cost	Accumulated amortization	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Capitalized subscriber acquisition costs	901,453	783,770	**117,683**	113,924
Frequencies (1)	220,104	-	**220,104**	220,104
Acquisition of operations (2)	43,847	20,116	**23,731**	30,127
Rights in channels	5,477	3,757	**1,720**	2,179
Prepaid long-term expenses in respect of a lease agreement	8,535	1,346	**7,189**	8,136
	1,179,416	808,989	**370,427**	374,470
Expenses for issue of debentures and raising other loans			**10,056**	13,434
			380,483	387,904

Company

			Balance for amortization	
	Cost	Accumulated amortization	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Deferred expenses				
Expenses for issue of debentures and raising loans and others			**10,056**	13,434

(1) Investment in cellular communication frequencies in third generation technology by Pelephone – see Note 8D(2).

(2) Acquisition of operations –

a. BezeqCall Communications acquired an operation from Nortel networks Israel (Sales and Marketing) Ltd., to obtain independent capability for providing maintenance, support and installation services to its customers. In addition, it entered into a transaction for the acquisition of the operations of Newkol Ltd., which provided NEP services for Coral exchanges and value added services for business customers.

b. In December 2003 Bezeq International acquired all the rights in the operations of Infonet, including expansion of the deployment of global communications networks and access to a wider range of advanced and quality communications services.

NOTE 11 – TAXES ON INCOME

A. GENERAL

The Income Tax Law (Adjustments for inflation), 5745-1985, effective since the 1985 tax year, introduced a method of measuring operating results for tax purposes on a real basis. The various adjustments required by this law are intended to bring about taxation on the basis of real income. However, adjustment of the nominal profit in accordance with the tax laws is not always identical to the profit reported according to the accounting standards of the IASB. As a result, differences arise between the reported profit in the financial statements and adjusted taxable income.

On deferred taxes in respect of these differences – see Notes 2P above and 11D below.

B. INCOME TAX INCLUDED IN THE STATEMENTS OF OPERATIONS

Consolidated

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Current taxes	**(268,563)**	(277,818)	(220,452)
Deferred taxes	**(142,841)**	(154,935)	169,588
Adjustment of deferred taxes due to changes in tax rates	**(55,090)**	(83,881)	-
Taxes for prior years, net	**36,900**	19,149	2,851
	(429,594)	(497,485)	(48,013))
Income from taxes in respect of a change in accounting method	**15,000**	-	-
	(414,594)	(497,485)	(48,013)

Company

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Current taxes	**(251,078)**	(274,057)	(216,941)
Deferred taxes	**(48,791)**	(49,916)	178,351
Adjustment of deferred taxes due to changes in tax rates	**(44,374)**	(78,713)	-
Taxes for prior years, net	**12,125**	15,607	5,077
	(332,118)	(387,079)	(33,513)
Income from taxes in respect of a change in accounting method	**15,000**	-	-
	(317,118)	(387,079)	(33,513)

NOTE 11 – TAXES ON INCOME (CONTD.)

C. RECONCILIATION BETWEEN THE THEORETICAL TAX ON PRE-TAX ADJUSTED EARNINGS AND THE TAX EXPENSE IN THE BOOKS

Consolidated

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Tax computed at the regular tax rate	**(343,113)**	(438,795)	17,046
Increase (saving) in tax liability in respect of:			
Inflationary erosion of advance tax payments	**-**	–	2,227
Exempt income and capital gains	**1,337**	2,270	1,411
Non-deductible expenses	**(41,813)**	(9,652)	(9,737)
Utilization of losses and benefits from prior years for which no deferred taxes were recorded	**16,864**	50,544	–
Losses and timing differences for which deferred tax assets were not created	**(94,897)**	(63,833)	(33,926)
Taxes for prior years, net	**36,900**	19,149	2,851
Revenues from taxes due to the change in accounting method	**15,000**		
Differences in the definition of equity and non-monetary assets for tax purposes	**60,384**	24,441	(27,511)
Adjustment of deferred taxes due to a change in tax rates	**(55,090)**	(83,881)	–
Decrease in deferred taxes due to the adjustment of deferred tax balances following the change in forecast			
Company consolidated for realization of the tax asset	**(21,339)**	–	–
Other	**11,173**	2,272	(374)
	(414,594)	(497,485)	(48,013)
Regular tax rate	**34**	35	36

NOTE 11 – TAXES ON INCOME (CONTD.)

C. RECONCILIATION BETWEEN THE THEORETICAL TAX ON PRE-TAX ADJUSTED EARNINGS AND THE TAX EXPENSE IN THE BOOKS (CONTD.)

Company

	For the year ended December 31		
	2005	**2004**	**2003**
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Tax computed at the regular tax rate	**(330,272)**	(345,696)	972
Increase (saving) in tax liability in respect of:			
Inflationary erosion of advance tax payments	**–**	–	2,051
Exempt income and capital gains	**1,337**	2,199	1,275
Non-deductible expenses	**(7,220)**	(9,022)	(8,726)
Utilization of losses and benefits from prior years for which no deferred taxes were recorded	**10,274**	12,250	–
Losses and timing differences for which a deferred tax asset was not created	**(11,469)**	(9,100)	(7,678)
Taxes for prior years, net	**12,125**	15,607	5,077
Tax revenues for changes in the accounting method	**15,000**	–	–
Differences in the definition of equity and non-monetary assets for tax purposes	**32,441**	22,177	(25,755)
Adjustment of deferred taxes due to a change in tax rates	**(44,374)**	(78,713)	–
Other	**5,040**	3,219	(729)
	(317,118)	(387,079)	(33,513)
Regular tax rate	**34**	35	36

D. DEFERRED TAXES

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Activity –				
Balance at beginning of year	**683,455**	769,536	**498,303**	611,633
Adjustment due to changes in tax rates	**(55,090)**	(83,881)	**(44,374)**	(78,713)
Charged to statement of operations for the year	**(142,841)**	(154,935)	**(48,791)**	(49,916)
Allocation of original difference to a tax asset	**-**	21,354		–
Acquisition of minority share in a proportionally consolidated company	**-**	112,540		–
Effect of the change in accounting method	**15,000**	–	**15,000**	–
Company consolidated for realization of the tax asset	**(21,339)**	–	–	–
Charged to statement of operations for prior years	**60,235**	18,841	**27,768**	15,299
Balance as at end of year	**539,420**	683,455	**447,906**	498,303

NOTE 11 – TAXES ON INCOME (CONTD.)

D. DEFERRED TAXES (CONTD.)

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Composition of deferred taxes –				
Difference between the adjusted value of fixed assets and other assets and their value for income tax purposes	**(386,209)**	(575,497)	**(28,346)**	(230,732)
Deductions and losses carried forward for tax purposes, net	**370,738**	495,101	**–**	63,726
Differences in the recognition of expenses relating to employee rights, doubtful debts and other	**554,891**	763,851	**476,252**	665,309
Total	**539,420**	683,455	**447,906**	498,303
Stated as follows:				
As part of current assets	**194,634**	237,319	**132,198**	159,023
As part of other assets	**344,786**	446,136	**315,708**	339,280
Total	**539,420**	683,455	**447,906**	498,303

Deferred taxes for companies in Israel are computed at the tax rate expected to apply on the date of the reversal – see Section E below.

NOTE 11 – TAXES ON INCOME (CONTD.)

E. AMENDMENTS TO THE INCOME TAX ORDINANCE

1. On June 29, 2004, the Knesset passed the Income Tax Ordinance Law (Number 140 and temporary provision), 5764-2004 (" the Amendment"), which prescribes a gradual reduction in the corporate tax rate from 36% to 30%, in the following manner:
   During the 2004 tax year the applicable tax rate will be 35%, in 2005 the applicable tax rate will be 34%, in 2006 the applicable tax rate will be 32%, and from 2007 onwards the applicable tax rate will be 30%.

   Current taxes and deferred tax balances as at December 31, 2004 are calculated in accordance with the new tax rates set out in the Amendment. The effect of the change on the consolidated financial statements as at the beginning of 2004 is an increase in tax expenses on revenue in the statement of operations and a reduction in deferred taxes in the Company balance sheet by approximately NIS 79 million, and approximately NIS 84 million in the consolidated balance sheet.

2. On July 25, 2005 the Knesset enacted an amendment to the Income Tax Ordinance (Number 147 and temporary provision), 5765-2005 ("Amendment 147"), which prescribes a gradual reduction of the corporate tax rate in the following manner:
   During the 2006 tax year the applicable tax rate will be 31%, in 2007 the applicable tax rate will be 29%, in 2008 the applicable tax rate will be 27%, in 2009 the applicable tax rate will be 26% and from 2010 onwards the corporate tax rate will be 25%. In addition, commencing 2010, with the reduction of the tax rate to 25%, every real capital gain will be taxed at 25%.

   Current taxes and deferred tax balances as at December 31, 2005 are calculated in accordance with the new tax rates set out in Amendment 147. The effect of the change on the consolidated financial statements as at the beginning of 2005 is an increase in tax expenses on revenue in the statement of operations and a reduction in deferred taxes in the Company balance sheets by approximately NIS 44 million, and approximately NIS 55 million in the consolidated balance sheets.

F. Realization of the deferred tax asset is contingent upon the existence of adequate taxable income in appropriate amounts in the future. The deferred tax asset is included in the financial statements since, according to the Group's business plans, its realization is anticipated.

(1) The balance of the losses and deductions carried forward, in respect of which the Company did not record deferred taxes due to uncertainty as to the possibility of realizing them, is approximately NIS 1,100,000 (2004 – NIS 26,000,000).

(2) Losses for tax purposes and capital losses carried forward of consolidated companies (except Pelephone), amount, as at the balance sheet date, to an adjusted amount of NIS 3,431 million (2004 – NIS 3,070 million). The consolidated companies did not create a tax asset in respect of losses of NIS 3,408 million.

(3) Pelephone recorded a tax asset of approximately NIS 366 million in respect of losses for tax purposes and a deduction for inflation carried forward to the following year and which, as at the balance sheet date, amount to an adjusted sum of approximately NIS 1,322 million (2004 – NIS 1,360 million). The net balance of the tax asset at Pelephone was recorded according to the assessment of Pelephone's Management that there is a high level of assurance that these losses will be realized in the foreseeable future. Realization of the balance of these deferred taxes is contingent upon the existence of adequate taxable income of in appropriate amounts in the coming years.

Realization of the balance of the losses and deductions carried forward is linked to the CPI pursuant to the law mentioned above.

NOTE 11 – TAXES ON INCOME (CONTD.)

G. Final tax assessments

(1) The Company has final tax assessments up to and including 2001.

(2) Bezeq International has final tax assessments up to and including 2003.

Under an assessment agreement signed in November 2005 between Bezeq International and the assessment officer concerning final assessments for the years 2000 – 2003, Bezeq International's business loss carried forward as at December 31, 2004 was reduced by approximately NIS 27 million. This amount will be allowed as a tax expense in subsequent years.

(3) Pelephone has final tax assessments up to and including the year ended December 31, 2003.

(4) BezeqCall Communications has final tax assessment up to and including 2002.

(5 Self-assessments filed by DBS up to 1999 are considered final. Assessment have been issued for DBS which do not recognize expenses of NIS 463 million. DBS is disputing the contentions of the tax authorities on which those assessments are based, and has appealed the assessments.

(6) Bezeq Online has received final assessments up to and including the 2003 tax year.

H. Value added tax

Value Added Tax assessments amounting to approximately NIS 18 million were issued to Pelephone for the period from June 2001 to December 2003, which are in dispute and regarding which Pelephone has objections. Pelephone has included a provision in its accounts for an amount it deems sufficient.

NOTE 12 – BANK CREDIT

		Consolidated	
		December 31 2005	**December 31 2004**
	Interest rate	**NIS thousands**	**NIS thousands**
Unlinked loans	Prime + 1.35	**75,191**	88,102

NOTE 13 – LONG-TERM LOANS

A. Composition

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Banks	**3,306,563**	4,162,573	**565,924**	1,003,312
Pension fund	**–**	26,758	**–**	26,758
Others	**107,980**	233	**–**	–
Supplier credit	**–**	7,352	**–**	–
	3,414,543	4,196,916	**565,924**	1,030,070
Less –				
Current maturities from banks	**1,262,583**	1,304,916	**531,402**	473,578
Current maturities from others	**–**	31,066	**–**	26,758
	2,151,960	2,860,934	**34,522**	529,734

B. LINKAGE AND INTEREST TERMS

		Consolidated		Company	
		December 31 2005	December 31 2004	December 31 2005	December 31 2004
	Interest rate	NIS thousands		NIS thousands	
Loans in foreign currency US dollar (*)	LIBOR+(0.45-0.65)	**563,867**	1,004,654	**563,867**	997,302
Loans linked to the CPI	3.9 - 11.0	**1,928,222**	2,122,825	**2,057**	6,010
Pension fund	6.1	**-**	26,758	**-**	26,758
		1,928,222	2,149,583	**2,057**	32,768
Shekel/dollar loans(**)	3.67-4.36	**230,150**	215,400	**-**	-
Unlinked loans	7.13 – 7.31 Prime + (1.5-1.35)	**692,304**	827,279	**-**	-
		3,414,543	4,196,916	**565,924**	1,030,070

(*) These loans bear interest at LIBOR plus a margin.
(**) The loan is renewed every three months in a mechanism determined for three years which will end in August 2006. The interest is computed under two possible alternatives – a shekel track and a dollar track.

NOTE 13 – LONG-TERM LOANS (CONTD.)

C. Repayment schedule

	Consolidated December 31, 2005 NIS thousands	Company December 31, 2005 NIS thousands
2007	**355,844**	**34,522**
2008	**292,517**	**-**
2009	**304,440**	**-**
2010	**283,016**	**-**
2011 and thereafter	**916,143**	**-**
	2,151,960	**34,522**

D. Security

(1) Long-term loan agreements of the Company, aggregating NIS 565,924 thousand, include certain conditions upon the occurrence of which the lender may demand immediate repayment of the loans, including:

– A change (without the lender's consent) in the nature of the Company's business, which would have a materially adverse effect on its business, assets or financial condition.

– Non-repayment of a material amount of the loan that has fallen due, or violation of the undertakings or representations made by the Company.

– Abrogation or change of a provision of law that would prevent the Company's operations or the fulfillment of its undertakings.

– The Company ceases to manage its affairs or enters into receivership or bankruptcy proceedings, etc.

– Some or all of the lien-holders realize the liens on the Company's assets.

– A complete or material reduction of the Company's authority to administer its affairs as a result of the intervention of an authority or a change in the Company's tariffs that will have a material effect on the future receipts of the Company (in loans from foreign banks only).

– In respect of loans amounting to NIS 105,624 thousand, upon the occurrence of an event which allows a demand for immediate repayment of other loans of the Company.

– In respect of the remaining balance of NIS 460,300 thousand, upon the occurrence of an event which allows a demand for immediate repayment of other loans of the Company and of material subsidiaries, or failure to comply with ratio of net financial debt to earnings before interest, taxes, depreciation and amortization (EBITDA) of 3 : 1 for the Group.

The Company's position is that as at the balance sheet date, it is in compliance with these financial covenants.

The Company created a negative pledge in favor of the lenders.

NOTE 13 – LONG-TERM LOANS (CONTD.)

D. SECURITY (CONTD.)

(2) a. Bank loans and debentures of Pelephone are secured by an irrevocable undertaking in favor of the banks, whereby Pelephone created a negative pledge in favor of the banks. This undertaking includes, *inter alia*:

(1) that its debts will not exceed three times its shareholders' equity;
(2) that as long as its debts exceed its shareholders' equity by a ratio of 2, Pelephone will not distribute dividends and will not pay management fees to the shareholders;
(3) that its total debts will not exceed NIS 3.8 billion (linked to the known CPI of January 2002);
(4) that Pelephone will not encumber in any way, including by way of a floating lien or a fixed lien, of any kind or rank, any or all of its assets (as these may be from time to time), in favor of any third party, without obtaining the prior written consent of those who provided the credit.

As at the date of the financial statements, Pelephone is in compliance with its obligations to the banks, the balance of which as at the balance sheet date is NIS 1,353 million.

b. Under the general license for cellular services, Pelephone may not sell, lease or pledge any of its assets which are used for performance of the license without the consent of the Minister of Communications, except –

(1) Encumbrance of one of the assets of the license in favor of a bank duly operating in Israel, for the purpose of receipt of bank credit, provided that it has notified the Ministry of Communications of the encumbrance it intends to record, whereby the encumbrance agreement includes a clause guaranteeing that in no case, will an exercise of the rights by the bank harm the provision of services under the license in any way;
(2) Sale of items of equipment at the time of an upgrading process, including sale of equipment by the trade-in method.

c. Bezeq International provided a negative pledge in favor of banks, whereby it may not encumber its assets without the bank's consent. As at December 31, 2005, Bezeq International has no obligations towards banks.

d. BezeqCall Communications provided a negative pledge and undertook to meet certain financial conditions in respect of loans from banking institutions, the balance of which as at the balance sheet date is approximately NIS 63 million.

e. The terms of the bank loans which DBS received, the balance of which as at December 31, 2005 is NIS 1,325 million, impose limitations concerning the lien or sale of certain of DBS's assets, a limitation on receipt of credit from other banks (without the prior approval of the lending bank), a limitation relating to the distribution of a dividend, a limitation relating to repayment of shareholders' loans and a limitation on transactions with an interested party, including a requirement to meet financial criteria, as follows: minimum total income, minimum operating surplus (as defined in the financing agreement), minimum operating surplus after deduction of investment in set top boxes (as defined in the financing agreement), maximum churn rate, maximum financing needs (as defined in the financing agreement) and maximum supplier credit and bank debt coverage needs and debt balance (as defined in the financing agreement). The values for compliance with the financial criteria vary, and are measured once every quarter. Failure to meet the financial criteria entitles the banks to demand early repayment of the loans which DBS received. As at December 31, 2005, DBS is in compliance with those criteria (after it was granted a benefit in December 2005 in relation to the maximum supplier credit stipulation). IN view of the projections of the management of DBS concerning its business results for 2006, DBS will need to take steps to obtain the approval of the banks to update the financial stipulations in the financing agreement. DBS is also negotiating with the banks for resolving a dispute relating to insurance obligations prescribed in the financing agreement.

NOTE 13 – LONG-TERM LOANS (CONTD.)

E. LOAN PROCUREMENT EXPENSES

Deferred expenses for raising loans amounted to NIS 9,601 thousand (2004 – NIS 10,855 thousand). The expenses are stated after deduction of accumulated amortization amounting to NIS 8,719 thousand (2004 – NIS 8,457 thousand).

NOTE 14 – DEBENTURES

A. COMPOSITION AND TERMS

		Consolidated		Company	
		December 31 2005	December 31 2004	December 31 2005	December 31 2004
	Interest rate	NIS thousands	NIS thousands	NIS thousands	NIS thousands
CPI-linked debentures issued to the public					
Debentures Series 4 and 5 (1)	4.8 – 5.3	**1,721,604**	850,847	**3,821,674**	3,410,936
Debentures issued to the public:					
In euro (2)	6.5	**1,593,387**	1,717,622	**1,593,387**	1,717,622
Debentures issued:					
Unlinked (3)	Bank of Israel interest + 0.5	**36,423**	109,179	**36,423**	109,179
Debentures issued to financial institutions and others:					
CPI-linked	3.9 - 6.35	**2,049,073**	1,355,286	**942,191**	1,055,286
Euro-linked	LIBOR + 0.8	**29,736**	32,086	**29,736**	32,086
		2,078,809	1,387,372	**971,927**	1,087,372
		5,430,223	4,065,020	**6,423,411**	6,325,109
Less – current maturities		**527,167**	240,481	**410,827**	210,481
		4,903,056	3,824,539	**6,012,584**	6,114,628

(1) The outstanding balance of the debentures is NIS 3,586,967,000, of which NIS 1,636,967,000 par value were issued to the public.

a. (1) In a tender offer and public offering pursuant to a prospectus published on May 24, 2004, the Company issued 1,200,000,000 debentures (Series 4) of a par value of NIS 1 each, payable in four equal annual installments in each of the years 2008 through 2011. The interest set for these debentures is 4.8% per annum. Of these debentures, 400 million were allotted, prior to the prospectus, to Bezeq Zahav (Holdings) Ltd. ("Bezeq Zahav"), a wholly owned and controlled subsidiary of the Company.
In addition, on May 20, 2004 the Company issued a series of 600 million debentures (Series 5) of NIS 1 par value each, of which 50 million were allotted to institutional investors and the remainder to Bezeq Zahav. These debentures are repayable in 6 equal annual installments in each of the years 2011 through 2016. The interest rate set for these debentures is 5.3% per annum. The debentures were listed for trading under the aforementioned prospectus.

NOTE 14 – DEBENTURES (CONTD.)

A. Composition and terms (contd.)

(2) During 2005 Bezeq Zahav sold NIS 400 million par value of the debentures (Series 4) which it had purchased from the Company. The proceeds from the sale in the amount of NIS 428,910 thousand, was transferred to the Company by Bezeq Zahav as repayment of a loan extended to it by the Company for purchase of the above debentures (Series 4). With the above sale of the debentures, Bezeq Zahav not longer holds any debentures (Series 4) of the Company, and all the debentures from this series, amounting to NIS 1,200,000,000 par value, are held by the public.

b. On December 9, 2004 the Company issued to Bezeq Zahav 1,500 million debentures (Series 5) of a par value of NIS 1 each. The debentures are registered in name, are repayable in six equal annual installments in each of the years 2011 to 2016, bear annual interest of 5.3% and are not secured by any lien.

The consideration in respect of the debentures was calculated at the market price of debentures from the same series at the close of trading on December 9, 2004, and is NIS 1,650 million.

The debentures were listed for trading on the stock exchange, and trading in them will be subject to blocking restrictions pursuant to the Securities Law and to a restriction which Bezeq Zahav undertook not to resell the debentures for any reason during the later of 12 months from the date of the allotment or until within three months from the date of sale of the State's holdings in the Company.

c. Bezeq Zahav financed the purchase of the above debentures by means of a loan granted to it by the Company for that purpose.

d. (1) On April 4, 2005 the Company completed a private placement of 286,967,000 debentures (Series 5) of a par value of NIS 1 each to institutional investors. The debentures are registered in name, are repayable in six equal annual installments in each of the years 2011 to 2016, bear annual interest of 5.3% and are not secured by any lien. The proceeds from the placement, NIS 315,663,700, were received on April 4, 2005. The purchase price in respect of NIS 1 par value of debentures (Series 5) was 110 points, reflecting an annual yield to redemption of approximately 4,46%.

(2) On August 17, 2005 Bezeq Zahav sold NIS 100 million par value of debentures (Series 5) of the Company. The consideration for this sale, NIS 110,950,000, was transferred to the Company as (partial) repayment of the loan extended to it by the Company for purchase of the above debentures (Series 5).

e. On February 27, 2005 Pelephone issued NIS 500 million of debentures in a private placement to institutional bodies at 4.4% interest. The debentures are repayable in twenty equal half-yearly payments commencing September 2005. On June 29, 2005 Pelephone issued NIS 333 million of debentures in a private placement to institutional bodies in consideration of their par value. The proceeds from the issue were received on July 3, 2005. The debentures are linked to the CPI, bear annual interest of 4.55% and will be repaid in twenty equal half-yearly payments commencing January 2006.

(2) The outstanding par value of the debentures held by the public is € 293,000,000.

(3) The outstanding par value of the debentures is NIS 36,443,333.

NOTE 14 – DEBENTURES (CONTD.)

B. REPAYMENT SCHEDULE

	Consolidated	Company
	December 31, 2005	December 31, 2005
	NIS thousands	NIS thousands
2007	**1,728,439**	**1,612,099**
2008	**666,977**	**550,637**
2009	**626,938**	**510,598**
2010	**625,999**	**509,659**
2011 and thereafter	**1,254,703**	**2,829,591**
	4,903,056	**6,012,584**

C. SECURITY

The debentures are not secured, except for a symbolic lien. However, the Company has undertaken that as long as the debentures are outstanding, it will refrain from encumbering its property with other liens.

The lenders are entitled to demand the immediate repayment of the debentures in cases where the Company does not repay its loans or violates the terms of the debentures, if a significant attachment is imposed on its assets (and not removed within 60 days), if a receiver is appointed for the Company's assets or a liquidation order is given against the Company, if the Company ceases to manage its business or if another lien-holder realizes the lien it has on the Company's assets.

In addition, some of the lenders, from whom the balance of loans as at December 31, 2005 is approximately NIS 343,698 thousand, may demand immediate repayment of the debentures if the State's holdings in the share capital of the Company falls below 26%. For this reason, the balance in the financial statements is stated under short-term liabilities (see also Note 1I).

Furthermore, in respect of a balance of NIS 1,593,387 thousand of debentures listed on the Luxembourg bourse which were issued to the public and are linked to the euro, upon the occurrence of an event enabling demand for immediate repayment of other loans of the Company (excluding an event deriving from a decrease in the State's holdings in the Company) and of its material subsidiaries as defined in the terms of the debentures (Pelephone is the only company meeting the definition of a material subsidiary in accordance with these debentures; it should be noted that DBS is not considered a material subsidiary as defined in the debentures), if the Company does not make the payments scheduled in respect of the debentures, if the Company or its material subsidiaries cease to manage their businesses or enter into receivership, liquidation proceedings and the like, and upon the occurrence of a number of additional events of non-compliance with the undertakings of the Company and its material subsidiaries, as set out therein.

Regarding the Company's application to the tax authorities for receipt of approval for exemption from the deduction of withholding tax from interest paid in respect of the above debentures, the Company reached an agreement with the assessment officer whereby it would be exempt from withholding tax from August 1, 2004 until the final repayment of the debentures. It was also agreed that where the ratio of debt to capital in the Company is greater than 1:1.5 debt to capital, the Company's financing expenses in the tax year would be adjusted for tax purposes but not by more than the amount of the financing expenses in respect of the debentures. This will be checked in the quarterly financial statements of the Company, and applied each quarter. In this regard, "debt" – any obligation bearing interest, linkage differentials or whose value changes as a result of changes in the interest or linkage differentials, except for an undertaking to the employees or former employees.
The Company believes that as at the balance sheet date, it is in compliance with all these conditions.

The Company has created a negative pledge in favor of the holders of the above debentures.

NOTE 14 – DEBENTURES (CONTD.)

D. ISSUANCE EXPENSES

The deferred expenses in respect of the issuance of the debentures amounted to NIS 20,475 thousand (2004 – NIS 39,266 thousand) and are stated net of accumulated amortization of NIS 11,427 thousand (2004 – NIS 29,520 thousand).

NOTE 15 – TRADE PAYABLES

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Suppliers of goods and services	**1,397,367**	1,671,261	**540,459**	648,218
Current maturities of long-term supplier credit	**3,347**	4,308	**–**	–
	1,400,714	1,675,569	**540,459**	648,218
Including subsidiaries	**–**	–	**75,175**	99,409

NOTE 16 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS

A. COMPOSITION

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Provision for early retirement (see D below)	**772,251**	1,190,447	**772,251**	1,190,447
Compensation for unutilized sick leave (see F below)	**54,865**	47,196	**54,865**	47,196
	827,116	1,237,643	**827,116**	1,237,643
Provision for severance pay (see B below)	**76,460**	76,629	**15,645**	13,186
Less – reserve in compensation fund	**38,271**	41,702	**–**	–
	38,189	34,927	**15,645**	13,186
	865,305	1,272,570	**842,761**	1,250,829
Stated as follows:				
In current liabilities	**567,878**	592,474	**567,878**	592,474
In long-term liabilities	**297,427**	680,096	**274,883**	658,355
	865,305	1,272,570	**842,761**	1,250,829

NOTE 16 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS (CONTD.)

B. ELIGIBILITY OF EMPLOYEES UPON REACHING RETIREMENT AGE

(1) The liability of the Company and its investee companies for severance benefits to employees is fully covered by current payments to pension funds and insurance companies and by the above liabilities. The accumulated amounts in the funds mentioned above are not under the management or control of the companies and therefore, are not reflected in the balance sheet.

(2) The pension rights of the Company's employees with respect to the period of their employment in government service until January 31, 1985, are covered by a pension fund ("Makefet Fund") which assumed the Government's liability in accordance with an agreement between the Government, the Company, the New General Federation of Labor (Histadrut) and the Fund.

C. EMPLOYEE RIGHTS BEFORE RETIREMENT AGE

The Company's liability to pay severance pay to employees leaving their employment under conditions entitling them to such benefits is covered, in respect of the period from February 1, 1985, by current deposits in pension funds and with insurance companies, as stated in section B above. Severance pay in respect of the period of government service up to January 31,1985, is actually paid by the Company, and the amounts accumulated with the Makefet Fund with respect to this period are held in that Fund for use in connection with the employees' rights. For a small number of employees (employed under special contracts), the Company has a commitment to pay severance pay exceeding the amount accumulated in the employee severance pay fund.

The liability of Group companies for pension and severance payments are mainly covered by current deposits in the employees' name in recognized pension and severance funds, and/or by acquisition of policies from insurance companies. The aforementioned deposited amounts are not included in the balance sheet since they are not under the control and management of the companies.

The severance pay liability included in the balance sheet represents the balance of the liability not covered by deposits and/or insurance policies as aforesaid, in accordance with existing labor agreements and in accordance with the wage components which the management of the companies believe entitle the employees to severance pay. In respect of this part of the liability, there is a reserve deposited in the Company's name in a recognized compensation fund. The reserves in compensation funds include linkage differentials and accrued interest, and are deposited in compensation funds in banks and an insurance company. Withdrawal from the funds is contingent upon fulfillment of the provisions of the Severance Pay Law.

Employees who transferred to the Company from government service ("transferred employees") and whose employment in the Company is ceased before reaching retirement age, are entitled, in certain conditions, if they so choose and under the provisions of the Civil Service Law (Retirees), to receive early pension benefits in lieu of severance pay. The cost of the early pension benefits (except for cases of sickness or disability up to retirement age), are to be borne by the Company. In recent years, most Company employees have retired under agreed early retirement plans, and therefore the chances of realization of the above liability are slight. Accordingly, no provision has been made in respect thereof in the financial statements, other than a provision for the early retirement plan described below.

NOTE 16 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS (CONTD.)

D. EARLY RETIREMENT PLANS

(1) In September 2000, the Company reached an agreement with workers' representatives to extend the 1997 collective agreement on early retirement (the "Retirement Agreement"). Under the Retirement Agreement, 1,770 additional employees, of whom up to 300 are not transferred employees, were to take early retirement between April 1, 2001 and December 31, 2006 (with the option of extending the final date of retirement for certain employees through December 31, 2008). Similarly, in accordance with the provisions of the agreement, the Company may terminate the employment of employees on the severance pay track in excess of the aforementioned quota. According to the agreement between the Company and workers' representatives, the funds raised by the Company in 2003, in the amount of approximately NIS 890 million, will be used to finance the costs of retirement of employees under the Retirement Agreement. Therefore, it was agreed that the funds raised would be held, managed and invested by the Company as part of its total monetary balances, and that shortly before the Government ceases to hold control of the Company, the Company will transfer the retirement funds to an external body which would manage and invest the retirement monies. As at the date of these financial statements, the Company and the workers' union had not reached agreement on implementing transfer of the retirement monies to an outside entity. The financing round was completed in 2003.

Under the retirement Agreement, 1,352 employees retired from the Company through December 31, 2005.

The Company's Management does not expect any significant costs arising as a result of employees who retire under the severance pay track (if they retire) under the Retirement Agreement, or under any other framework, and therefore no provision has been made in the financial statements.

In May 2003, the Knesset approved the Israeli Economic Recovery Plan (Legislative Amendments for Achieving Budgetary Targets and Economic Policy for the 2003 and 2004 Financial Years) Law, 5763-2003. This law includes, *inter alia*, an amendment to the Supervision of Insurance Business Law, 5741-1981, which relates to the old pension funds operating at a deficit, including the Makefet Fund. Under the amendment, the retirement terms of all members of these pension funds were made equal, in accordance with uniform articles which, amended by law, became valid on October 1, 2003, such that the rights of members of those pension funds who were a party to special pension agreements were harmed.

On March 18, 2004, an amendment to the Retirement Agreement was signed between the Company, the New General Workers' Trade Union and the workers' union, under which certain amendments to the present Retirement Agreement were agreed upon with the aim of clarifying the uncertainties arising out of the amendment of the Supervision of Insurance Business Law. *Inter alia*, it was agreed that by September 30, 2004, 400 employees would retire, and it was also agreed that the retirement conditions of all transferred employees who take a pension under the Retirement Agreement commencing September 2000, would remain in force despite the amendments to the Pension Law and that the Company would bear any additional costs that might be required.

On April 1, 2004, the Commissioner for Capital Markets, Insurance and Savings published a circular regarding "Employer-Financed Early Retirement in Old Pension Funds". According to the circular, the discount rate for capitalizing the cost of early pension was changed from 3.5% to 3% and the management fees were raised to 1.75%. As a result of these and additional updates, the Company recorded an additional provision of approximately NIS 105 million in its financial statements as at December 31, 2004.

NOTE 16 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS (CONTD.)

D. EARLY RETIREMENT PLANS (CONTD.)

(1) (contd.)

On April 17, 2005 a special collective agreement was signed between the Company, the workers' union and the Histadrut, enabling early retirement of employees through the alternative entity to Makefet Fund. On June 28, 2005, a contract was completed and signed between the Company and Harel Insurance Co. Ltd. ("Harel"). The commitment regulates pension payments in respect of early retirement, as well as retirement pension payment differentials deriving from legislative amendments to the Israeli Economy Recovery Plan Law (Legislative amendments for attaining budget targets and economic policy for fiscal years 2003 and 2004), 5763-2003 for employees who retired commencing at the end of 2003 and beginning of 2004, and/or who will retire from the Company in accordance with the special collective agreement for retirement dated September 2000, as amended on March 18, 2004 ("the Retirement Agreement"). Subsequent to signing the agreement with Harel, the special collective agreement between the Company, the workers' union and the Histadrut was revised and amended on the same date (June 28, 2005).

It is noted that all the approvals required for the agreement with Harel and the special collective agreement dated April 17, 2005, and its amendment to come into force, as signed between the Company and the workers' union and the Histadrut and regulating the early retirement of employees through Harel as substitute for the Makefet Fund, have been obtained.

As a result of the agreement described above and also subsequent to adjustments deriving from updated assessments of the pension liability the Company reduced the provision for early retirement in the financial statements for 2005 by approximately NIS 90 million.

(2) It is noted that before completion of transfer of the State's holdings in the Company to Ap.Sb.Ar, a document of principles was signed between Ap.Sb.Ar. and the workers union, regarding signing a future detailed agreement between the Company and the union, which includes reference to a change in the organizational structure of the Company involving the retirement and/or laying off of employees and employees' rights; capital reduction while maintaining the financial strength of the Company, and employee compensation. As at the date of publication of these financial statements, negotiations have commenced between the Company's Management and the union on these issues.

E. Under the collective agreements applicable to labor relations in the Company and pursuant to the agreements with Makefet ("the Fund"), Company employees who are transferred employees retain the option of retiring under one of two retirement tracks. The method of calculating the cost of early retirement of these employees is laid down in the provisions of several agreements and documents drawn up between the Company and Fund during the years 1990-1996, including a letter of understanding drawn up and signed by them in 1996. The Company contends that the Fund violated the provisions of the agreements in general and those of the letter of understanding in particular, in that when it calculated the costs of early retirement for transferred employees, it determined the data on the basis of the assumption that these employees had chosen the track with the higher cost of purchase, irrespective of the track those employees had actually chosen. According to an actuarial opinion prepared for the Company, the difference between the payments collected by the Fund from the Company according to its calculations and the rate of those costs had they been made, as the Company alleges, on the basis of the retirement track actually chosen by those employees, is a nominal cumulative amount of more than NIS 128 million, the reimbursement of which the Company is suing the Fund. On November 20, 2003, the Company filed another claim against the Fund for additional amounts of approximately NIS 80 million in respect of other components. The Fund submitted data on the previous retirees. On the basis of these data, together with the previous file, a revised actuarial opinion was prepared which quantified the total amount of the claim as at the date of its filing at approximately NIS 280 million. The Fund filed statements of defense in which it rejects the allegations of the Company and alleges that it acted in accordance with the agreements between it and the Company.

NOTE 16 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS (CONTD.)

F. COMPENSATION FOR UNUTILIZED SICK LEAVE

The financial statements include a provision for compensation in respect of unutilized sick leave for all entitled employees, in accordance with the conditions laid down in the employment agreement, and based on past experience concerning the utilization and redemption of sick leave days at age 55.

NOTE 17 – OTHER CURRENT LIABILITIES

	Consolidated		Company	
	December 31 2005	December 31 2004	December 31 2005	December 31 2004
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
The Government of Israel in respect of royalties	**247,978**	**244,886**	**140,996**	**145,121**
Wages and salaries (1) (2)	**314,383**	397,666	**205,433**	286,360
Provision for vacation pay	**87,479**	113,144	**73,319**	73,370
Governmental agencies	**128,536**	102,229	**33,689**	15,635
Accrued interest	**146,431**	235,352	**173,137**	165,124
Payables in respect of derivatives	**77,400**	57,635	**75,657**	47,827
Other accrued expenses	**296,981**	166,086	**129,409**	103,519
Current maturities in respect of prepaid income	**38,298**	34,547	**19,533**	21,643
Provision for claims in respect of salary and pension components	**50,469**	50,595	**50,469**	50,595
	1,387,955	1,402,140	**901,642**	909,194
Including subsidiaries	**–**	–	**67,053**	76,308
(1) Including current maturities of a long-term loan from a pension fund	**–**	26,758	**–**	26,758

(2) Including a provision for a special benefit for employees in respect of the proportional period in the report year (9 months) in which the Company was controlled by the State.

NOTE 18 – OTHER LONG-TERM LIABILITIES

	Consolidated		Company	
	December 31 2005	**December 31 2004**	**December 31 2005**	**December 31 2004**
	NIS thousands	**NIS thousands**	**NIS thousands**	**NIS thousands**
Prepaid income	**15,583**	25,750	**15,583**	20,937
Liabilities in respect of an onerous contract (1)	**9,135**	9,247	**–**	–
Liabilities in respect of derivatives	**–**	438	**–**	–
Checks payable	**3,711**	11,940	**–**	437
Customer deposits	**5,652**	–	**–**	–
	34,081	47,375	**15,583**	21,374

(1) In the course of its business and as part of the setting up of Bezeq International and receipt of assets from the Company, Bezeq International entered into agreements granting it rights to use transmission equipment (old-generation undersea cables) for periods ending between 2016 and 2024. Under those agreements, Bezeq International is obligated to pay fixed monthly amounts, irrespective of the extent of the use it makes of those cables. The Management of Bezeq International estimates that the unavoidable costs for compliance with those agreements exceed the anticipated financial benefit that will accrue to it from use of the undersea cables. This assessment, together with the decision of Bezeq International's management not to operate the undersea cables, formed the basis for charging a provision in the financial statements. The balance of the provision as at December 31, 2005, which reflects the capitalized value as at that date of all the unavoidable costs that Bezeq International must pay the owners of the undersea cables until the end of the terms of the agreements is NIS 9,135 thousand (on December 31, 2004 – NIS 9,247 thousand).

NOTE 19 – CONTINGENT LIABILITIES

A. CLAIMS

Below are details of the status of contingent liabilities of the Company and investee companies as at December 31, 2005, in respect of which the maximum possible exposure is considerable.

(1) In September 1997 a claim was filed against the Company and the State in the Jerusalem Regional Labor Court. The claim was filed on behalf of 128 senior employees employed under personal employment contracts. The essence of the claim is the plaintiffs' allegation that since October 1, 1996, they have been entitled to a 33% salary increase, commensurate with the raise given at that time to Knesset members and to senior civil servants whose salaries are linked to those of Knesset members. The total amount of the claim in respect of salary differentials is approximately NIS 12 million. In addition, delay differentials are claimed in respect of these amounts. The Company contended that it pays the plaintiffs' salaries according to the directives of the Government Companies Authority. The State joined as a party to the proceeding and filed a final opinion written by the Attorney General, which supports the position of the Government Companies Authority that there is no obligation to grant the senior employees the salary increment demanded. In a hearing on January 27, 1998, the State's representative stated that the Attorney General had given his decision that the Government Companies Authority had no obligation to order a 33% raise in the salaries of the senior employees, and that the Government Companies Authority had exercised its discretion reasonably on this matter when it decided not to accede to the claim. The claim was dismissed, as was the appeal filed against its dismissal. On May 23, 2004, the plaintiffs filed a petition in the Supreme Court, requesting that the decision of the National Labor Court be annulled. On June 23, 2004, the Company, through its legal advisers, filed a preliminary response to the petition, seeking its dismissal *in limine*. A decision on these claims has not yet been made and a hearing was scheduled for March 22, 2005, in the Supreme Court. On May 2, 2005, the Supreme Court gave its ruling, dismissing the petition.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (contd.)

(2) a. In December 1998 the Antitrust Commissioner published notice that the Investigations Department of the Antitrust Authority ("the Authority") had completed an investigation it had carried out over the past year, regarding *prima facie* suspicion of restrictive agreements between Koor Industries, Telrad, Tadiran, the Company and a subsidiary company, BezeqCall Communications Ltd. ("BezeqCall Communications"), concerning the supply of large exchanges (Public Switching) and Network End Point ("NEP") exchanges.

In the field of Public Switching, the Authority's investigation found, according to the notice, suspected collaboration between Telrad and Tadiran against the Company, and suspected restrictive practices between the Company, Koor, Telrad and Tadiran, which include a commitment by the Company not to purchase exchanges from a third vendor; division of purchases between Telrad and Tadiran according to a predetermined calculation, i.e. the ostensible pre-arrangement of the competition between the companies in relation to the Company and an undertaking by the Company not to purchase equipment from the two companies through tenders. It was suspected that these undertakings, or some of them, in the relevant circumstances, constitute violation of the provisions of the Antitrust Law. According to the Commissioner, from the findings of the investigation, it appears, ostensibly, that in fact the Company purchased exchanges from one vendor (Koor Industries) – at prices which were seemingly much higher than those the Company would have paid had it not restricted itself and had the entire market not been blocked to other equipment suppliers by the aforementioned arrangement.

In the NEP field, the findings of the Authority's investigation gave *prima facie* indication of a series of restrictive arrangements and attempted offenses in the NEP field, between BezeqCall Communications, Telrad and Tadiran.

On March 3, 2002, the Company and certain persons who were serving as its officers during the relevant period, were summoned to a hearing by the Antitrust Authority. The summons (which relates to the investigation of the public switching issue only) stated that the Authority was considering committing the Company for trial on the basis of offenses against the Antitrust Law.

In 2004, the Authority gave notice that it does not intend to file indictments in connection with this affair. However, the Authority also notified the Company that it was considering issuing a determination against the Company, under Section 43 of the Antitrust Law, concerning the public switching field, and that the Company was invited to attend a hearing on the matter. In reply, the Company gave notice that it refuses to attend the hearing, for the same reasons it refused to attend the hearing in connection with the intention to file an indictment against it.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (contd.)

(2) a. (contd.)

Following dismissal of the Company's petition on March 2, 2005, to direct the Authority to hold a hearing for the Company, to submit security material to the Company for it to study and to refrain from issuing a determination under Section 43 of the Antitrust Law, discussions were held between the Company and the Authority in an attempt to arrive at an agreed order (which would also preclude issue of the determination), and resulted in agreement being reached between them on the wording of an agreed order which would be filed in the Antitrust Court for approval. The text of the order includes an undertaking by the Company to pay the State Treasury approximately NIS 2 million without admitting to violation of the Antitrust Law, and the Authority's confirmation that it will refrain from instituting any proceedings against the Company in connection with the public switching affair. The Authority recently published the text of the agreed order. The Company, based on its legal advisers, believes that an application for approval of the agreed order will be filed by the Authority, with the concurrence of the Company, in the near future, and that taking into consideration that the Antitrust Court approved an application similar to the agreed order which was filed in this affair by Telrad and Tadiran, it is probable that this application will also be approved by the Court.

b. On September 21, 2004, a claim and an application for approval as a class action were filed in the Jerusalem District Court against the Company and several other defendants (including Telrad and Tadiran) and against the State of Israel-Ministry of Communications as a formal defendant. The claim was filed by the plaintiff under the Antitrust Law,5748-1988, and Article 29 of the Civil Procedure Regulations, 5744-1984. According to the plaintiff, the defendants unlawfully formed a number of cartels which divided up the communications exchange market in Israel and set the prices of the exchanges, where the Company was party to those agreements as a customer of Telrad and Tadiran. It is alleged that these arrangements gave rise to unnecessary expenses for the Company, resulting in an unjustified rise in the Company's tariffs in a cumulative amount of NIS 1,750 million. Most of the claim is based on causes ostensibly found in the Antitrust Law for causes established in other laws, by means of an attempt to include the claim among the actions which can be filed by virtue of Article 29 of the Civil Procedures Regulations,5744-1984. On March 8, 2005, the Company filed its response to the application for approval of the claim as a class action, in which it also requested that the Court dismiss the application *in limine* and at least on its merits. In addition, on September 1, 2005, a decision was given in the A.S.T. ruling in the matter of the status and application of Article 29 for filing class actions, which limits, at least at this stage, the use of Article 29 as a tool for filing class actions.

In these circumstances, due to the complexity of the claim and the early stage of the proceeding, the case has not yet advanced to a stage where a realistic assessment can be made for the prospects of the claim itself.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(2) c. Applications by Company shareholders relating to the filing of claims against suppliers and/or officers:

In November 2000 an application was received from a Company shareholder, demanding that the Company take legal action against the abovementioned suppliers of communications equipment, and giving notice that in his estimation, the Company had suffered a loss of approximately NIS 392 million as a result of the cartel. In his application, the shareholder reserves the right to file a derivative claim pursuant to Section 194 of the Companies Law. The Company replied that it was monitoring developments in the matter, that it had requested the investigation material from the Authority and that it would formulate its position on the basis of the Authority's decision and any findings there might be. In November 2001 a similar application was made by another shareholder. The Company replied that it was still awaiting the decision of the Authority. On November 2, 2004, another similar application was made by a Company shareholder who believes that the Company should file an action in respect of losses caused by the suppliers. The Company replied that his application did not contain the factual and legal basis required under the Companies Law, and added that to the extent the Company explains, as part of the class action referred to in section b. above, or if information that comes to the Company shows that it has cause of action, it will be ready to institute proceedings to defend its rights.

In addition, on November 29, 2004, an application was received demanding that a claim be filed against whoever served in the Company as directors and/or as senior managers from the end of the 1980s to 2004 (inclusive), in which the officers would be required to compensate the Company in respect of all the excess payments made by the Company to its equipment suppliers and which, due to the omission of those officers, the Company is unable to claim from those equipment suppliers.

On January 30, 2005, the Company replied that it rejects everything stated and alleged in the demand, since the Company was not in a position which would enable it to formulate a reasoned and final position on the matter of the public switching and that it has no cause of action against any of its officers.

In the opinion of the Company's legal advisers, in these matters it is not certain that on the dates relevant to the contents of the demand there was no cause of claim against some of its officers.

(3) In March 1999 a claim was filed against the Company in the Jerusalem Regional Labor Court by a group of employees who had been employed as non-permanent workers at the Ministry of Communications and were transferred to the Company when it commenced operations. The plaintiffs are requesting that the Labor Court determine that they are entitled to all the benefits which were granted to transferred permanent employees, graduates of Bezeq College and retired Ministry of Communications employees. In the hearing of the Company's application for dismissal, the parties reached agreement regarding partial striking out and a narrowing of the claim in respect of some of its components, following which, exposure decreased in respect of the claim. During 2002 the plaintiffs withdrew their consent to narrow the claim. The Labor Court must now rule whether it approves the withdrawal of consent. In a preliminary hearing the parties agreed to split the hearing so that in the first stage the court would hear only the dispute on whether the plaintiffs have the status of "transferred employees". Based on the outcome of this stage, the plaintiffs will give notice of continuing the case proceedings. In the opinion of the Company the plaintiffs are not considered "transferred employees" and collective labor agreements differentiate between transferred employees and other employees regarding pension and other rights.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(3) (contd.)

On March 6, 2005, a partial decision was given, dismissing the plaintiffs' allegations as to their status as "transferred employees", and the Court's position was that the partial decision should be made final. The plaintiffs' lawyer was supposed to give notice of the plaintiffs' position on the matter. On August 11, 2005, when no such notice was received on behalf of the plaintiffs, a decision was given that the partial decision is a final decision, thereby dismissing the claim.

(4) Several claims are pending against the Company concerning the recognition of various salary components as pensionable components and the recognition of various components of the determining wage for severance pay as detailed below:

a. In September 2000, a claim was filed in the Jerusalem Regional Labor Court against the Company by 2,423 retired employees of the Company, who were transferred from the Ministry of Communications to the Company when it commenced operations. The plaintiffs are seeking declaratory relief from the Labor Court, which will determine that the payments they received for grossing up of tax, clothing allowance and incentive pay are regular salary which should be considered as part of their determining wage for the purpose of calculating their pension and for the payments made to them upon retirement, and should be included in the calculation of hourly pay value and the calculation of the percentage increments. The plaintiffs are also seeking declaratory relief which will determine that their last determining salary for pension should be calculated according to the last salary paid to each of them for the last month of work, and not according to the average staff grade which each of them held. The Company filed a preliminary application for the claim to be dismissed and/or stricken *in limine*. The preliminary allegations made in that application are dismissal for limitation, strike for absence of material details, strike for absence of financial quantification, and causal arguments relying on the retirement agreements.

On June 24, 2004, the Regional Court gave its decision, in which the claim was stricken *in limine*. The Court ruled that the plaintiffs were not a homogenous group in that each of them has different data relevant to his claim, that the claim cannot be conducted as if it were a class action, that it is a monetary claim which was not properly quantified, and it does not contain all the facts required for it to be quantified. The Court also determined that the pensioners' organization is not a workers' organization as referred to in Section 3 of the Collective Agreements Law, that it is not an action in a collective dispute and that the consent of the organization is not sufficient for filing a claim in the name of each of the 2,423 plaintiffs. On October 10, 2004, this decision was appealed in the National Labor Court. On September 6, 2005 .the National Labor Court allowed the appeal of the plaintiffs against striking the claim *in limine*, and determined that since the appellants had petitioned for a declaratory decision which tests entitlement to include various components in the determining salary for pension, a proceeding of a declaratory decision in this case is correct, since what is sought is a determination in principle. Accordingly, the National Court set aside the decision of the Regional Court and directed that the dismissal of the claim be cancelled.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(4) (contd.)

b. On February 24, 2002, a "notice of a party to a collective dispute" ("the Notice"), was received at the Company's offices, which was filed in the Jerusalem Regional Labor Court on February 21, 2002 by the New General Federation of Workers in the name of all Company employees. The applicant alleges that payments for grossing up of tax, the component of administrative on-call duty benefits and clothing allowances which were and are paid to Company employees, are regular pay which form part of the determining salary of every employee, including for the calculation of payments upon retirement, redemption of holidays, grants, acclimatization payments, percentage increments and hourly pay value and that various payments and provisions should be made in respect thereof, including for pension purposes. On October 20, 2002, the Attorney General gave notice that he would be joining the claim, and he later submitted his position that the application in all its parts should be dismissed.

c. A group of employees filed a claim against the Company in the Tel Aviv-Jaffa Regional Labor Court concerning the inclusion of a number of components as part of the determining pay for pension. The Company and the group of employees participated in a mediation proceeding, which was terminated, and attempts to reach a settlement between the parties, which were conducted concurrently with the ongoing trial, were unsuccessful. Summations have been filed by the plaintiffs, and the Company must now file its summations. The financial statements include a provision which Management believes, based on its legal advisers, is appropriate.

d. A number of other, individual claims are pending against the Company, filed by employees and former employees and concerning recognition of various salary components as pensionable components and recognition of various components as part of the determining salary for severance pay.

The wide-ranging effect of these claims is most considerable, and the maximum exposure in respect of these claims could, under certain assumptions, reach an amount of approximately NIS 2.6 billion. Nevertheless, in view of two decisions in the matter of the administrative on-call duty component and in the matter of the grossing up of tax described in this Note below, the Company has revised the assessment, relying on its external legal advisers, and calculated that exposure of approximately NIS 2.2 billion (out of the maximum exposure) is unlikely to be utilized. Out of the balance of the exposure in the amount of NIS 392 million, in respect of component claims which the Company, relying on its external legal advisers, believes the risk cannot be assessed or in which the Company has good prospects for success, the Company did not include a provision in its financial statements, other than a provision of NIS 50 million in respect of administrative on-call duty benefits (according to the calculation formula determined in the decision on this matter) and in respect of a possible settlement in the claim described in Note 19A(4)c above.

Concerning the risk assessment of the claims described in this section –

On July 14, 2003, the National Labor Court gave its decision on an appeal in another claim which was filed by seven former employees of the Company, which recognized the component of administrative on-call duty benefits as a pension component, considering the factual circumstances in that case.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(4) (contd.)

On October 13, 2004, the National Labor Court gave its decision in the appeal of dismissal of a claim filed by a former employee of the Company, the main part of which was a claim for the inclusion of the administrative on-call duty benefits and a jubilee grant as part of the determining salary for making various payments, including for pension purposes. The Court determined in its ruling that the source of the right to administrative on-call duty benefits is contractual and that the parties to the agreement may determine the terms of granting the right, its scope and its limits, and therefore, full validity should be given to the limits set forth in the Company's procedure, whereby the payment for the administrative on-call duty benefit is not considered as salary in any way insofar as rights deriving from agreements are concerned. Nevertheless, the decision determined that the administrative on-call duty benefits should be included in the determining salary for the calculation of rights under law (Hours of Work and Rest Law and the Annual Vacation Law). In the opinion of the Company's external legal advisers, this decision appears to close the door on the claim that the component of administrative on-call duty benefits should be seen as salary in every respect. In view of the above and in accordance with the resolution of the Board of Directors of the Company of October 28, 2004, the Company has reduced the provision it made in its financial statements in respect of the component of administrative on-call duty benefits by approximately NIS 145 million.

On January 17, 2005, in a petition to which the Company is not a party, the Supreme Court ruled against a decision of the National Labor Court that the grossing up of tax component (in respect of the value of use of a vehicle and in respect of reimbursement of telephone expenses) should be recognized as part of the determining salary for pension purposes. The Supreme Court set aside the decision of the National Labor Court and determined that the grossing up of the tax component paid as aforesaid is not part of the determining salary for pension purposes, since that component is secondary to the salary increment in respect of which the tax is grossed up, and it should be treated in the same way as a salary increment. Since this petition refers to increments which are not part of the determining salary for pension purposes, the grossing up of tax component on the increments is also not part of the determining salary for pension purposes. Following this decision of the Supreme Court and in view of the opinion of the Company's external legal advisers that following the Supreme Court ruling there is a good chance that claims filed against the Company relating to the grossing up of tax component can be dismissed, and after examining the salary components which are grossed for tax in the Company, it appears that the risk to which the Company is exposed in relation to recognition of the grossing up of tax component as a pensionable component in pending claims against it has been reduced considerably, and accordingly, no provision has been made in the financial statements. In view of the above, the provision of approximately NIS 62 million for the grossing up of tax component which was recorded in the books, has been cancelled.

(5) On September 7, 2000, an action and an application for approval as a class action were filed against the Company in the Tel Aviv – Jaffa District Court, based on Article 29 of the Civil Proceedings Regulations, 5744-1984 ("Article 29"). The amount of the claim is estimated at approximately NIS 110 million. According to the plaintiff, the Company unlawfully collected "collection fees" from its subscribers for Company bills which were not promptly paid, before it had started any collection actions in connection with the plaintiffs' debt. According to the plaintiff, Article 2 of the Telecommunications Regulations (Arrearage interest and collection fees), 5747-1987 ("the Collection Regulations") authorizes the Company to collect collection expenses for a bill in arrears only if the collection action against the consumer has been initiated, and therefore the Company exceeded its authority. In addition, the plaintiff alleges that charging collection fees before taking any action is an administrative offense, fraud, under Section 56 of the Torts Ordinance (New Version), false representation, negligence, harm to the proprietary right, violation of legislated duty, unjust enrichment, and fulfillment of a contract in bad faith. There are two main reliefs requested by the plaintiff – declaratory, in which the Court is requested to declare that the collection of "collection expenses" by the Company in the circumstances described in the claim was unlawful and that the Company may not continue to collect such expenses in the future, and an "operative – financial" relief, for reimbursement of said amounts.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(5) (contd.)

On January 7, 2001, the Company filed its response to the application for approval of the claim as a class action, to which it attached an economic opinion of an auditor. In its response the Company argued that Article 29 does not constitute legal grounds for filing class actions and therefore the application for approval should be dismissed *in limine*. Alternatively, the Company argued that the claim does not meet the criteria of Article 29 for filing a class action. The Company also alleged in its response that it charges the collection expenses only from subscribers who have caused it to incur expenses due to arrears in payment, that the plaintiff's interpretation of the provisions of the Collection Regulations are groundless, and that it acted lawfully. On February 8, 2001, the plaintiff filed his reply to the Company's response.

On October 18, 2001, an additional class action was filed in the Tel Aviv-Jaffa District Court on exactly the same matter – unlawful charging of collection fees on Company bills not paid on time, before the Company had started any collection action. The plaintiff alleges that this action constitutes exploitation of the consumer's difficulties, in contravention of the Consumer Protection Law, 5741-1981 ("the Consumer Protection Law"), as well as unjust enrichment. The amount of the class action is estimated by the plaintiff at about NIS 21 million. On December 16, 2001, the court approved a stay, requested by the Company, until after a decision is given on the application for approval as a class action in the first claim described in this sub-section, in view of the similarity of the causes of action in the two cases.

On February 20, 2003, the District Court approved the first action as a class action in the name of whoever was charged collection fees by the Company despite having paid the relevant bill before the Company commenced collection actions as explained in the statement of claim, from March 7, 1997 to the date of filing the claim. In its decision, the court determined that the Company's authority to collect collection expenses depends on the initiation of means of collection involving costs, and that the Company had not presented proof that retrieving the data of payment arrears, before any action is taken against them, involves costs. In addition, the court determined that Article 29, on which the application for approval relies, is suitable grounds for a class action. On March 17, 2003. the District Court suspended the proceedings in the claim pending a decision on the application for leave to appeal which would be filed by the Company. On March 20, 2003, the Company filed an application in the Supreme Court for leave to appeal the decision to allow the action as a class action. In its application, the Company claimed, *inter alia*, that that the District Court's interpretation of the Collection Regulations is erroneous and disregards their language and purpose, and that even were its interpretation correct, the plaintiff would still have no cause against the Company since the Company collects the collection expenses by virtue of the Collection Regulations only from subscribers whose arrears require additional handling, which the Company would not have required had the payment been made on time.

The Company further alleged that the District Court erred when it determined that no proof was presented of the Company bearing expenses in relation to a bill that is not promptly paid before the elapse of 14 days' arrears, since an affidavit of the Company was presented which described the expenses it incurs due to the fact of arrears, as well as an economic opinion on the same matter, which the court had disregarded in its decision.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(5) (contd.)

On April 2, 2003, a precedent-setting ruling was given by the Supreme Court (in another case, to which the Company is not a party), stating that a class action cannot be filed by virtue of Article 29 where no specific arrangement is made in principal legislation for filing such action ("the A.S.T. Ruling"). It should be noted that an application for an additional hearing of this Supreme Court ruling was filed (and allowed). Based on the above, the court ruled that the response to the Company's application for leave to appeal in the matter of the first action described in this sub-section, would be postponed pending a decision in the additional hearing in the other case. On September 1, 2005, a decision was given in the additional hearing on the A.S.T. Ruling ("the Additional Hearing"), whereby class actions cannot be filed under Article 29. On September 14, 2005, the Supreme Court requested the position of the parties on resumption of the proceedings in the application for leave to appeal, in light of the decision in the Additional Hearing. The Company submitted its position to the court that, in light of the decision in the Additional hearing, the application for leave to appeal should be allowed. The plaintiff stated that that the hearing of the application should continue be suspended pending completion of the process of legislation of the Class Action Law. The hearing in the case was scheduled for 27 September, 2006. In view of the Court's determination in the matter of Article 29 and the absence of reference to evidence in the case, as well as the A.S.T. Ruling, the Company, relying on its legal advisers, believes that there is a reasonable chance that the application for leave to appeal (and the appeal itself) will be allowed. Nevertheless, the Company, relaying on its legal advisers, is unable, at this stage, to assess whether and how the proposed class action law currently going through legislative phases, will affect the proceedings in the case.

(6) On September 28, 2000, three plaintiffs filed a claim in the Tel Aviv-Jaffa District Court, together with an application for approval as a class action, against the Company, Bezeq International and the other international call operators. The plaintiffs estimated the total value of the claim in millions of shekels per year.

According to the plaintiffs, commencing October 20, 1998, the Company unlawfully collected 17% VAT for some collect calls from abroad received by its subscribers in Israel (where according to the plaintiffs, the Company serves, in this matter, as a "collection conduit" for the international call operator to which the payment is eventually due), in contravention of the VAT law and its regulations and in violation of a legislated duty, in a way which breaches existing contractual commitments and with bad faith conduct in fulfilling those contracts and with negligent conduct. The plaintiffs also make allegations against the international call operators concerning collection of VAT for calls made abroad by means of a telephone card. According to the plaintiffs, the total damages sustained by the class in respect of the unlawful collection of VAT for all the calls made from abroad to Israel in the relevant period (from October 20, 1998), amount to millions of shekels per year.

The plaintiffs applied mainly for two reliefs: declaratory, stating that each of the defendants violated its duties under the agreement between it and a member of the group which contracted with it, and monetary, for restitution of the aforesaid amounts (compensation for the loss sustained by the members of the group whom the plaintiffs wish to represent, in the aforementioned amounts). The defendants filed responses and Bezeq International filed an application to dismiss *in limine* the application for approval as a class action. On June 18, 2001, the Attorney General gave notice that he would join the proceeding. On January 6, 2002, the Court decided that the Director of VAT should be added as another defendant in the action and in the application for its approval as a class action, and it dismissed the application of Bezeq International for dismissal *in limine*. In a hearing on February 28, 2002, the plaintiff's lawyer explained that the plaintiffs were not suing the international call companies for independent relief but for the same reimbursement of VAT that the Director of VAT will repay to them if the Court allows the claim. The plaintiff's lawyer also proposed that the international call companies be seen as formal defendants. In view of the A.S.T Ruling, the Court decided, on August 25, 2003, to strike the application for approval as a class action and as a result, also the action itself.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(6) (contd.)

On October 13, 2003, the plaintiff filed an appeal against this decision in the Supreme Court. On April 18, 2004, the Supreme Court decided to stay the proceedings in the case pending a decision of the Supreme Court in the Additional Hearing in the matter of A.S.T. On September 1, 2005 (see also Note 19A(5) above), the appellants filed their position that they should be allowed a stay of proceedings until the enactment of a new class action law or alternatively, they should be allowed to amend their claim. The Company gave notice that it opposes a stay of the proceeding in view of the A.S.T. Ruling, and that in any case since the Company is a formal defendant in the case, it should be stricken from the proceeding. For this reason, the Company made no provisions in this matter in the financial statements. Bezeq International, in the response it filed in the Court, stated that based on the decision of the District Court in the case and on the decision in the A.S.T. case, there was no alternative but to dismiss the appeal. The legal advisers of Bezeq International estimate, based on the above, that Bezeq International will not be affected by the outcome of the hearing, and accordingly, Bezeq International also made no provision in its financial statements in respect of this matter.

(7) In September 2001, an application was filed in the Tel Aviv-Jaffa District Court for approval of a class action against the Company. The plaintiffs allege that in view of certain amendments to the Telecommunications Regulations, the maximum payment that could be collected from a Company subscriber who called a Pelephone subscriber in off-peak hours during the period between October 2000 and December 31, 2000, was lower than the amount actually collected. The applicants estimate the amount of the claim, as at the date of filing the application for approval of a class action, at about NIS 44 million. The Company filed a response to the application for approval, in which it alleged mainly that it simply acts as a non-discretionary collection contractor and that the conditions required for approval of the claim as a class action have not been met. On May 12, 2002, the Company's request to conjoin Pelephone as a party to the proceeding was allowed. On August 29, 2002, Pelephone filed a response to the application for approval as a class action, to which it attached confirmation from the Ministry of Communications that the plaintiffs' interpretation does not reflect the intention of the promulgator of the Regulations. The parties filed their summations in the application for approval of the class action. On January 14, 2005, the Court gave its decision denying the application for approval. No appeal against this decision was filed, and the proceeding has ended.

(8) a. In March 2003 a claim was filed in the Tel Aviv-Jaffa District Court against the Company, the Broadcasting Authority and the State of Israel by various plaintiffs from Moshav Porath in the Sharon region, including the estates of deceased persons, for compensation due to physical harm pursuant to the Torts Ordinance. The statement of claim alleges violation of legislated duties and acts and/or failures allegedly perpetrated by the defendants jointly and/or severally in connection with the operation of the Hillel broadcasting station, which is located near the homes of the plaintiffs. It is also alleged that as a result, the plaintiffs were subjected to prohibited radiation from the broadcasting station causing bodily harm, which in the most part, had ended in the death of some of the plaintiffs.

The amount of the claim stated by the plaintiffs is "more than NIS 15 million", and the same claim notes that the plaintiffs will also petition to split the reliefs so that they will reserve the right to sue later for other financial damages which are not bodily harm, such as damage to crops and loss of value of land. According to the notice of the plaintiffs' lawyer, which was given before the claim was filed, this claim is an initial claim and it is intended that additional claims of other residents who have been harmed by radiation from the Hillel station will be filed later.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(8) a. (contd.)

The Company filed a statement of defense to which it attached expert opinions in occupational medicine and non-ionizing radiation safety, which state, *inter alia*, that there is no causal connection between the broadcasts of the Hillel station and the alleged cancer of the plaintiffs. The plaintiffs filed a response in which they argue against the Company's experts and their opinions. In the opinion of the Company, relying on its external legal advisers, whose opinion is based on the expert opinions mentioned above, the chances of the claim being dismissed are greater than the chances that the claim against the Company will be allowed. Accordingly, no provision has been included in the financial statements in respect of this claim.

It should be noted that following an application for dismissal *in limine* filed by the Company, a partial decision was given in favor of the Company, denying the claim of five plaintiffs who died before the Company commenced operation of the station.

The Company is reserving its arguments against the other defendants, the State of Israel and the Broadcasting Authority. These arguments relate mainly to the fact that the station was operated by the Company for and on behalf of the other defendants, in accordance with the directives and operational requirements of the other defendants or any of them, and that the Company acted in accordance with the provisions of any law and with the directives of the various authorities, including those which were responsible for the broadcasting activity from the station.

b. On June 13, 2004, another claim was filed in the Tel Aviv-Jaffa District Court by 25 plaintiffs from Moshav Porath and Moshav Ein Vered, including 11 heirs of the estates of deceased persons, against the Company, the Broadcasting Authority and the State of Israel, for compensation in respect of bodily harm (18 of the plaintiffs are suing the Company, the Broadcasting Authority and the State, and 7 plaintiffs are suing only the Broadcasting Authority and the State).

The additional claim alleges violation of legislated duties and acts and/or failures allegedly perpetrated by the defendants jointly and/or severally in connection with the operation of the Hillel broadcasting station, which is located near the homes of the plaintiffs. It is alleged that as a result, the plaintiffs were subjected to prohibited radiation from the broadcasting station causing bodily harm, which had ended in the death of some of the plaintiffs.

The amount of the compensation demanded in the additional claim is not estimated (although the claim is in the jurisdiction of the District Court, i.e. more than NIS 2.5 million), and the compensation is based on financial and non-financial damages items which are listed in respect of each plaintiff, together with punitive compensation. The claim also states that the plaintiffs will petition to split the reliefs so that they will reserve the right to sue later for other financial damages which are not bodily harm allegedly caused, and that this refers to damage to crops, loss of value of land, deterrence of potential investors and the like. According to the plaintiffs, these damages are "in excess of millions of shekels", but have not yet been calculated. The Company filed a statement of defense on October 31, 2004.

At this stage, the external legal advisers of the Company are still unable to assess the chances of the Company's defense against the claim. Nevertheless, since the claim is similar in essence to the first claim mentioned above, they expect (subject to the aforesaid) that the chances that this claim will be dismissed are greater than the chances of it being allowed, and accordingly, no provisions has been included in the financial statements in respect of these claims.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(8) (contd.)

c. On May 9, 2005, the Company received a claim for damages amounting to NIS 46 million which was filed by 14 plaintiffs who were and/or are residents of the moshavim Porath, Ein Vered, Ein Sarid and of the settlement of Kadima, against the Company, the Broadcasting Authority and the State of Israel. According to the plaintiffs, the negligence and/or failures of the defendants in operating the Hillel broadcasting station, which is situated near the above locations, and which for many decades has allowed uncontrolled and hazardous exposure to radiation from the Hillel broadcasting station and from installations connected with it, have caused them (or their heirs) bodily harm and property damage of various kinds. As described in the above Note, the opinions of experts in occupational medicine and in non-ionizing radiation safety, filed by the Company as part of its defense in the two claims, state, *inter alia*, that there is no causal connection between the broadcasts of the Hillel station and the cancer allegedly suffered by the plaintiffs in those claims. In relation to these claims, the Company, relying on its external legal advisers (whose opinion is supported by the aforementioned expert opinions), believes that the chances of the claims being dismissed are greater than the chances of their being allowed. Accordingly, no provision has been made in the financial statements in respect of this claim.

   The plaintiffs in the three claims described above have filed an application for consolidation of their hearing.

d. On May 23, 2005, the Company received a claim for damages in respect of property damage and financial loss amounting to approximately NIS 141 million, which were allegedly sustained by 53 plaintiffs who were and/or are residents of Moshav Porath. The claim was filed in the Tel Aviv-Jaffa District Court against the Company, the Broadcasting Authority and the State of Israel. According to the plaintiffs, the negligence and/or failures of the defendants in operating the Hillel broadcasting station, which is situated near the moshav, were the direct cause of irreversible damage to agricultural fields owned by moshav residents, harm to the livelihood of the moshav and enormous financial losses, due, *inter alia*, to the effects of operation of the Hillel broadcasting station and the electromagnetic fields radiating from it towards the agricultural land of the plaintiffs, which the plaintiffs allege damaged their crops and prevented them from making proper use of their agricultural land. In addition, an application was filed to split the reliefs so as to enable future claims for damages. On September 1, 2005, the plaintiffs filed an application to amend the statement of claim, in which they wished to delete 23 plaintiffs and to reduce the amount of the claim of the remaining 30 plaintiffs, so that the amount of compensation sued for in the statement of claim would be approximately NIS 35 million.

   Furthermore, at this stage a partial court fee has been paid and 6 of the plaintiffs have filed an amended application for full or partial exemption from payment of the fee. The court has not yet given its decision on these applications. The statement of defense on behalf of the Company and the other defendants has not yet been filed. The Company, relying on its external legal advisers, cannot assess at this early stage the chances of the outcome of the claim against the Company, and accordingly has not included a provision in respect of this claim in the financial statements.

   Regarding all of the above claims, the Company has defense arguments against the other defendants – the State of Israel and the Broadcasting Authority. These arguments relate mainly to the fact that the Company operated the station for and on behalf of those other defendants in accordance with their directives and operational requirements, and that the Company acted in accordance with the directives of the various authorities, including those responsible for the broadcasting activities from the Hillel station.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(8) d. (contd.)

Furthermore, the Company also has allegations against insurers related to the cases, where investigation of the insurance cover for the events which are the subject of the claims against the insurance companies has not yet been completed.

It should be noted that on December 31, 2003, the Company ceased all broadcasts from the station, as required by the State and the Broadcasting Authority, and since that date the site has ceased to be use as a broadcasting site.

(9) In January 2002 a claim for payment of monetary compensation of approximately NIS 57 million and for writs of mandamus were filed in the Tel Aviv-Jaffa District Court by an international communications operator against the Company and Bezeq International. The claim makes allegations concerning the process of customer allocation to the international communications operators. According to the plaintiff, it is entitled to compensation from the Company and from Bezeq International in respect of postponement of implementation of the allocation process, in respect of diverting those being allocated to Bezeq International by unlawfully including them in the coordinated listing and removing them from the customer allocation process, and in respect of losses it sustained due to the method of the voice announcement of the possibility of dialing from card-operated public telephones. Alternatively, the plaintiff alleges that it is entitled to reimbursement of access fees which it paid to the Company under an interconnect agreement which was allegedly imposed upon it unlawfully. The plaintiff also requests that the court give orders directing investigations and accounts be made in relation to certain actions in the allocation process and for changing the order of the voice announcement in public telephones so as to ensure, in its opinion, equality among the international operators. On April 22, 2002, the Company filed a statement of defense, in which it denied the allegations of the plaintiff. In the statement of defense the Company claimed, *inter alia*, that postponement of the date for completing the allocation process derived, among other things, from objective failures and difficulties. The Company also alleged that in the subscriber survey its role was purely technical, and involved nothing more than collating the data and preparing a file of those who participated. The Company relied, for this purpose, on data conveyed to it by the three international operators, and was extremely careful in processing the data and even on its own initiative, beyond the call of duty, identified errors that had occurred in them (insofar as these were apparently reasonable to discover, by means of the systems at its disposal).

In addition, the Company filed a third party notice against the Ministry of Communications in the full amount of the claim. In the notice the Company alleges, *inter alia*, (as in the statement of defense) that in all its actions relating to the allocation process, the Company acted as the agent and long arm of the Ministry of Communications and under its instruction, that the Ministry of Communications devised, planned and supervised the allocation process, directed it and dictated the manner of its implementation and the timetables for each stage of its implementation, and to the extent that it was flawed in any way, the Ministry of Communications is exclusively responsible.

Bezeq International also filed a statement of defense and a third party notice.

On July 3, 2002, the plaintiff filed its reply. On October 14, 2002, the Ministry of Communications filed a statement of defense to the third party notice filed against it by the Company and Bezeq International. The case has been transferred for mediation. The Company, relying on its external legal advisers, is unable, at this stage, to estimate the outcome of the mediation proceeding. If it ends without a result and the claim is returned to the court, the Company believes, relying on its legal advisers, that its defense arguments against the claim have a reasonable chance of being allowed. Accordingly, no provision has been made in the financial statements in respect of this claim.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(9) (contd.)

The legal advisers of Bezeq International estimate, regarding the cause relating to postponement of application of the customer allocation process and relating to another cause which concerns the fact that in the pubic telephone system, Bezeq International appears first, Bezeq International has reasonable defense arguments, and regarding the cause concerning the unlawful inclusion of customers in the main file (its share out of the total claim being approximately NIS 29 million), Bezeq International estimates that the risk is reasonable but it is unlikely that it will be ordered to pay any part of that amount. However, at this early stage of the proceeding – before the start of the evidentiary hearings which will examine the evidence on which the plaintiff's damages are based, and before the plaintiff's damages have been examined by experts on behalf of Bezeq International, the legal advisers of Bezeq International are unable to estimate the rate of the risk. Accordingly, Bezeq International decided not to include a provision in respect of this claim in the financial statements.

(10) In January 2002 the Company received a letter of demand from a supplier, alleging that an order issued by the Company to the supplier for a total sum of approximately NIS 31 million, is valid. According to the Company, the order was contingent upon suspending conditions which were not fulfilled, and therefore the order is not valid. About a year ago the supplier sent the Company a letter to which it attached a draft statement of claim for approximately 2 million euro and the Company's reply rejected the supplier's allegations and repeated its own allegations. In the opinion of the Company, relying on the legal advisers who are handling the demand on its behalf, the chances of the Company's defense, should a claim to be filed against it in this matter, cannot be assessed, and therefore no provision has been included in the financial statements in respect of this claim.

(11) In February 2002 a claim and application for recognition as a class action were filed against the Company in the Tel Aviv-Jaffa District Court, concerning reimbursement of a commission which the plaintiff alleges was collected unlawfully, for calls in Israel from a public telephone operated by means of a BezeqCard. The amount of the class action is estimated by the plaintiff at about NIS 15 million as at the date of filing the claim. Summations have been filed in the matter of the application for recognition as a class action and the case is awaiting a decision on that application. On February 23, 2004, the Telecommunications Regulations (Payments for telecommunications services listed in the addendum to the Law) (Amendment of the 5759-1999, 5760-2000 and 5761-2001 Regulations), 5764-2004 were published, in which the Telecommunications Regulations (Payments for telecommunications services listed in the addendum to the Law) were amended for the years 1999-2001. In the opinion of the legal advisers who are handling the claim for the Company, following the above amendment, there are no longer grounds for the claim and the application for recognition as a class action, and accordingly, no provision has been made in the financial statements in respect of this claim.

(12) On July 25, 2002, the Company received a claim for monetary and declaratory relief together with an application for recognition as a class action by virtue of both Article 29 of the Civil Proceedings Regulations and the Antitrust Law 1988 – 5748 ("the Antitrust Law"), which had been filed in the Tel Aviv - Jaffa District Court against the Company. The plaintiffs, who contend that they are Company subscribers or use its services, allege that the Company unlawfully collects interest on arrears, as defined in a directive concerning Accountant General's interest rates, in respect of arrears in payment for services provided by other communications providers, which are included in the bill which the Company issues to its subscribers. The plaintiffs allege that the Company may collect such interest only in respect of arrears in payment for the telecommunication services provided by the Company itself.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(12) (contd.)

They further allege that the Company does not transfer to the other communications providers the full amount of interest on arrears it collects, and that by collecting the additional arrearage interest, the Company enriched itself unlawfully at their expense and perpetrated an administrative offense against them. The plaintiffs are seeking declaratory relief including, for the Company's abuse of its monopolistic status, and that the Company be directed to reimburse the interest on arrears that it allegedly collected unlawfully. If approved as a class action, the total amount of the claim is estimated by the plaintiffs to be in the tens of millions of shekels.

On February 11, 2003, the Company filed its response to the application. Its arguments are that since it is the one which bears the costs of collecting the bill from the subscribers, there can be no dispute that it is entitled to interest for arrears in payment of the bills both legally by virtue of the Adjudication of Interest and Linkage Law and by virtue of the licenses of the other communications providers, that according to a practical interpretation of the interest regulations it is entitled to collect the additional arrearage interest at the rate prescribed in those regulations. In addition, the Company argued that the basic assumption of the plaintiffs, that the arrearage interest under the interest regulations is necessarily higher than the arrearage interest under the licenses of the communications providers and/or under the Adjudication of Interest and Linkage Law, is unfounded and incorrect. In this context the Company showed that in calculating the damages, the plaintiffs have disregarded several benefits that the Company grants its subscribers, as a result of which some of the plaintiffs suffered no damages and some suffered damages that were much lower than alleged in the claim, and in any case the plaintiffs in the class action suffered no damage and therefore cannot serve as appropriate plaintiffs in a class action, that Article 29 cannot serve as legal grounds for filing a class action, and that the filing of the action is tainted with serious delay which is sufficient for its dismissal.

Following the A.S.T. Ruling, the plaintiffs filed an agreed claim in January 2004 and an amended application for approval from which the parts relating to Article 29 and causes of action the source of which was not the Antitrust Law, had been stricken. The Company filed its amended response on May 3, 2004. On June 6, 2005, the District Court gave its decision dismissing the plaintiffs' claim and their application for its approval as a class action, and ordering them to pay costs. On September 18, 2005, the plaintiffs filed an appeal against the decision in the Supreme Court. The appeal is scheduled for November 1, 2006. The Company, relying on its legal advisers, is unable to assess the chances of the appeal at this stage, and therefore no provision has been included in the financial statements in respect of this claim.

(13) On December 22, 2002, a financial claim for grant of a declaratory order and injunction, together with an application for recognition as a class action, were filed in the Tel Aviv-Jaffa District Court against the Company. The plaintiffs, who contend that they are subscribers of cellular communications providers, allege that the Company is misleading the consumer public regarding calls to 1-800 or 1-700 numbers, into thinking that such numbers are toll-free calls, whereas in fact, the consumer who calls such a number from a cellular telephone is charged by the cellular companies for air-time for those calls. According to the plaintiffs, in so doing, the Company is perpetrating torts according to the Consumer Protection Law (deception of the consumers, including deception in advertising, exploitation of the distress of consumers and refraining from disclosure of essential information to consumers), and all the members of the group represented in the action (all the consumers who called 1-800 or 1-700 from a cellular telephone during the seven years prior to the date of filing the claim) have consequently sustained losses. The estimated amount of the claim is approximately NIS 700 million, which includes compensation for financial loss, non-financial damages and punitive damages. The court is also requested to give temporary and permanent injunctions against the Company, to cease misleading consumers and to refrain in the future from advertising or making any other representation liable to mislead consumers regarding the price of such calls.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(13) (contd.)

On March 27, 2003, the Company filed its response to the application for approval, in which it alleged, *inter alia*, that no transaction was made between it and the plaintiffs, that the advertisements did not make representations towards the plaintiffs and that all the representations of the Company were correct. In addition, the Company contended that the claim does not meet even one of the conditions required under the Consumer Protection Law for its approval as a class action.

The case is in preliminary proceedings. In the opinion of the Company, relying on its external legal advisers, the chances and implications of the claim cannot be estimated at this stage, and therefore no provision has been made in the financial statements in respect of this claim.

(14) On May 27, 2003, a statement of claim was received at the Company's offices together with an application for recognition as a class action, which were filed against the Company in the Tel Aviv-Jaffa District Court. The plaintiff who describes himself as "a private internet user" alleges in his claim that the Company refuses to install splitters for high speed internet lines of the broadband ADSL/frame relay type used for internet service in condominiums, and does so, allegedly, in order to increase its profits. The plaintiff, who is seeking to represent all the internet users in Israel, further alleges that the Company's refusal to install the splitters causes losses of thousands of shekels each year to every private internet user, since the connection of a number of tenants in a condominium on one telephone line using such splitters would considerably reduce the fees paid to the Company by each consumer. The pretexts for the claim as they appear in the statement of claim, are cited by virtue of the Antitrust Law, the Torts Ordinance and the Unjust Enrichment Law and not by case law. The plaintiff also alleges fraud and material deception under the Consumer Protection Law. The amount of the claim is estimated by the plaintiff at NIS 2.5 billion (NIS 10,000 per consumer), which he alleges is the loss sustained by the plaintiffs. The plaintiff also petitions to charge the Company, in addition, with special and punitive damages, and for an order for the Company to give accounts for all private internet users in respect of the amounts received from them from the time each user started using the service until the date of the reply. The stage of evidentiary hearings has ended and the case is scheduled for written summations. The main points of the Company's arguments are that there is no basis in law for obligating it to connect a number of users on one "broadband" and that the service and the tariff collected by the Company for it were approved by the Ministry of Communications.

On February 5, 2006 the Court decided to dismiss the claim, and determined that the plaintiff has no personal grounds for the claim, that he failed to show how he was misled and that he had not proved that the price collected by the Company is not a fair price. The plaintiff filed an application for the court to reconsider the decision, which was given without the summations of the plaintiff. The Company filed a response in the court, in which it argued that there is no legal or other basis for the plaintiff's application.

(15) The Makefet Fund ("the Fund") received a directive from the Capital Markets Division at the Ministry of Finance to fulfill the undertakings it had made in connection with the change in the retirement tracks of about 600 Company retirees, contingent upon the Company paying the Fund NIS 50 million. The Company notified the Fund that it is demanding the continued implementation of the agreement that enabled transfer from one retirement track to another at no additional cost to the Company, since the Fund had undertaken not to impose any additional cost on the Company. Subsequently, the Fund stopped allowing Company retirees to transfer from one track to another and also ceased complete or partial performance of the retirement agreement with regard to pensions paid in respect of April 2002. On January 11, 2004, a claim was filed in the Tel Aviv-Jaffa Regional Labor Court by 66 retirees who had retired under the retirement agreement of November 1997, alleging that they had elected to receive their pensions under Track B since the personal agreement signed with them under that track embodied a promise of amendment of the wage that determines their pensions in accordance with the "Yellow Note" agreement (i.e. additional payment of up to NIS 650 per employee).

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(15) (contd.)

According to the plaintiffs, that promise had not been kept, and therefore a collective agreement was signed on April 2, 2001, which was intended to enable employees to transfer from Track B to Track A. The plaintiffs contend that the April 2001 agreement was applied to only about 70 employees of the 600 or so who wished to exercise their right under it. The claim is consequently for enforcement of the April 2001 agreement. The claim, which was filed initially by 66 retirees, was broadened when, with the approval of the court, other retirees were added to bring the total to 264 retirees. After a preliminary hearing on December 5, 2004, the Company and the Fund filed applications for dismissal of the claim, and alternatively, for its quantification. On June 6, 2005, the court decided not to dismiss the claim *in limine* and not to strike the retirees' organization as plaintiff, but it directed that the sections in the claim concerning demands for payment be stricken (as long as a fee had not been quantified or paid for them), so that in fact, the claim remained declaratory only. An application similar to two earlier applications was filed in the court, for joining another group of employees to this claim. This application is to add another 34 employees. If it is allowed, the total number of employees named in the claim will be 299. Principal evidence affidavits were filed on behalf of the plaintiffs, as well as an application to add another 20 retirees. In the opinion of the Management of the Company, relying on its external legal advisers, the Company is not at risk of actual legal exposure in respect of the claim, and accordingly, no provision has been made in respect thereof in the financial statements.

(16) At the beginning of July 2004 an action for declaratory relief against Makefet ("the Fund"), the State of Israel and the Company, was filed in the Tel Aviv Regional Labor Court by the Organization of Bezeq Retirees and six of its members, alleging that the defendants breached agreements for binding arrangements that were made upon the transfer of the employees from the civil service to the Company. According to the plaintiffs, the uniform code under the Economic Recovery of Israel Law should not be applied to them as retirees, and alternatively, the defendants or any of them must compensate them for application of the uniform code. The Company filed an application for dismissal of the claim *in limine*, citing as its reasons, *inter alia*, that the claim is not quantified, and that in the amendment to the retirement agreement from March 18, 2004, the Company undertook that the rights of employees who retired from the Company commencing from the date of application of the uniform code, would not be harmed. The plaintiffs responded to the application, and the Company is awaiting the decision of the court. In the opinion of the external legal advisers of the Company, there are weighty preliminary arguments for dismissal of the action, and there is only a low risk that the action will actually impose a financial cost on the Company. Accordingly, no provision in respect of this claim is included in the financial statements.

(17) During 2004, various claims were filed in the Regional Labor Courts in Tel Aviv-Jaffa and Be'er Sheva, against the Company and/or Makefet ("the Fund"), by a number of employees who retired from the Company with a disability pension due to their medical condition. Against a background of the pension reforms, these employees were called for a repeat medical examination and were notified of a reduction to their pension, initially of 50%. In their claim, the employees are demanding payment of a full disability pension. A procedural agreement was drafted between the parties, in which the applications for temporary reliefs have been consolidated into the main case, and pending a decision in the main case, the Fund will pay advances to supplement the pension to its full rate and the Company will pay the Fund compensation for insurance of half of the salary. If the claim against the Fund is allowed, this compensation will be returned to the Company. On June 20, 2005, the Supervision of Insurance Business Law was amended so that for a retiree whose disability was determined before October 2003 and who has been disabled for at least five years, or who reached retirement age prior to the decision to reduce his disability, the reduction decision will be cancelled. Following this amendment, the claims of those retirees who meet these criteria became superfluous and were stricken.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(17) (contd.)

The proceeding in one claim to which the amendment of the law does not apply, will go forward. In the opinion of the Company, relying on its external legal advisers, this claim has a reasonable chance of being allowed against the Fund and dismissed against the Company, and therefore no provision has been included in the financial statements.

(18) On October 19, 2004, a claim together with an application for its recognition as a class action was filed in the Tel Aviv-Jaffa District Court. The statement of claim alleges that the Company adds VAT to the arrearage interest it collects from its subscribers in respect of arrears in payment, thereby generating over-collection, in contravention of the law, since the arrearage interest of the Accountant General at the Ministry of Finance, which the Company is entitled to collect, includes the VAT component. The claim is grounded, *inter alia*, in the Antitrust Law, 5748-1988 and the Consumer Protection Law, 5741-1981. The amount of the claim against the Company is estimated by the plaintiffs at approximately NIS 87 million (if it is ruled that the ground for the action is only the Consumer Protection Law, the amount of the claim is estimated by the plaintiffs at about NIS 56 million). A decision was given on May 3, 2005, stating that the Attorney General's position is required on the question of whether he intends to intervene in the proceeding, and to explain his position on whether Accountant General's interest includes a VAT component or not. On September 15, 2005, the Attorney General filed his position, which is according to existing law, Accountant General's arrearage interest does not include the addition of VAT. The court directed the plaintiffs to file their position on the position of the Attorney General and to say whether they intend to continue conducting the claim. On December 21, 2005, the District Court gave its decision to strike the class action. It should be noted that the decision to strike the claim came in the wake of an agreed notice filed by the parties, stating that in view of the detailed response of the Company to the application for recognition of the claim as a class action, and in view of the position of the Attorney General, the plaintiff wished to withdraw from the proceeding and it was stricken.

(19) On February 10, 2005, the Company received a claim and an application for its approval as a class action which were filed in the Haifa District Court. The statement of claim alleges that the Company's charges for internet access in the "WOW Extra" and "WOW" campaigns in the summer of 2004 and in its calculations, constituted deception, fraud, unjust enrichment and overcharging. The plaintiff also alleges that the acts and/or failures of the defendant constitute a criminal offense under the Consumer Protection Law, 5741-1981, and a tortious offense. In addition, the plaintiff requests discovery of facts. The grounds for the claim are by virtue of the Consumer Protection Law, and the preliminary estimated amount of the class action is NIS 96 million. From an investigation carried out by the Company, it transpires that the plaintiff was not overcharged and that for official-technical reasons the charge was split into a charge and a credit. Following the Company's response to the application, the plaintiff applied to strike his claim, and subsequently, on June 8, 2005, with the consent of the parties, the Haifa District Court decided to strike the claim.

(20) In the matter of the dispute between the Company and the Ministry of Communications regarding payment of royalties in respect of interconnect revenues from cellular subscribers and Company subscribers in the period between April 1999 and the end of 2000, on July 25, 2005, the Company received a letter from the Director General of the Ministry of Communications requiring that the Company pay the above disputed royalties debt, which amounts to approximately NIS 17 million. The Company replied to the Ministry of Communications that it is adhering to its legal position, namely, that in respect of the relevant period the Company was not required to pay royalties to the State for interconnection of calls from cellular subscribers to Company subscribers, and that the Ministry gave no reasons for its decision and did not relate to the contentions and data presented recently by the Company to professional personnel at the Ministry. The Company also requested an urgent meeting to discuss the matter with the Director General of the Ministry of Communications, and to postpone the demand for payment until after the aforementioned discussion.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(20) (Contd.)

On February 19, 2006, the reply of the Ministry of Communications was sent to the Company, stating that the Ministry sees no justification for further discussions on the question, and requesting that the Company transfer the payment of the royalties to the Ministry without further delay.

The legal advisers of the Company are unable, at this stage, to assess the outcome of the dispute. Nevertheless, the Company believes that its outcome will not have material consequences for the financial results of the Company's operations or for its financial condition.

(21) On August 15, 2005, the Company received a claim and application for its approval as a class action under the Antitrust Law, 5748-1988 and the Consumer Protection Law, 5741-1981, concerning the Company's method of billing for calls made using the Company's phone card – BezeqCard.
The plaintiff alleges that the pulse on which the Company bases the cost of calls made with a BezeqCard is based on a whole minute rather than seconds, as prescribed in law.
The amount of the class action is estimated by the plaintiff at approximately NIS 38 million (a claim in respect of the past seven years, based on the plaintiff's allegation of advertisements about the number of BezeqCard-holders, the number of minutes of the call made using a BezeqCard and the plaintiff's own calculations). On January 1, 2006, the Company filed an application to strike the action *in limine* , as well as a response and opposition to the application for recognition of the claim as a class action. On February 22, 2006, the Company received the decision of the court, stating that in the absence of a response to the Company's application to strike and dismiss the claim *in limine*, the application for recognition as a class action had been struck out *in limine*.

(22) On December 25, 2005, a claim was filed against the Company in the Tel Aviv-Jaffa District Court, together with an application for recognition as a class action, under the Consumer Protection Law, 5741-1981. The claim alleges, *inter alia*, that the Company collected, unlawfully and while misleading its subscribers, payments for surfing the internet with WOW's high-speed service ("the Service"), even though it allegedly did not provide the Service in certain areas at the requested surfing speed and even though it is allegedly technically unable to provide the Service in those areas at that speed. The plaintiffs estimate the amount of the class action at approximately NIS 100 million for all subscribers, where they allege that this loss has two sources: surplus payment collected by the Company from its subscribers for the Service, and an additional payment made by every subscriber to his internet service provider on the assumption that he is indeed surfing at high speed. Based on the above, the plaintiffs are requesting that the court order the restitution of the monies which they contend were collected unlawfully from subscribers, and an order to adjust the payment of the "subscriber fees" from now on for all subscribers. In addition, the plaintiffs are petitioning, *inter alia*, for orders obliging the Company to inform its subscribers of the non-feasibility of providing the Service, to refrain from advertising and marketing the Service in a way which seems to show that the Service will be provided to whoever pays for it, to look into the technical feasibility of the Service before making a commitment with the customer, to end collection of the subscriber fees from subscribers to whom the Service cannot be provided at the stated speed, and to refrain from making agreements with consumers in cases where the Company is technically unable to provide the declared surfing speed. The Company has been given an extension until March 1, 2006, to file its response.

At this early stage of the claim, the Company is still studying the case and drafting its response, and is unable, based on its legal advisers, to estimate the chances of the outcome of the claim. Accordingly, no provision is included in the financial statements in respect of this claim.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(23) In November 1997 a claim was filed in the Tel Aviv-Jaffa District Court, together with an application to recognize the claim as a class action, against the Company, Bezeq International, the Chairman of the Board of Directors of Bezeq International and the then CEO of Bezeq International. The claim alleges, *inter alia*, that the Antitrust Commissioner had determined that Bezeq International had abused its status in the international calls market and had implemented a deliberate policy of misleading the public on the subject of overseas call tariffs when it refrained from clarifying to the public that only those who registered as Bezeq International subscribers would enjoy the reduced tariffs. The amount of the class action is estimated by the plaintiffs at approximately NIS 50 million. In December 1997 the Company was struck from the claim. On June 19, 2001, the District Court decided to deny the application for approval as a class action. On September 20, 2001, the decision of the District Court was appealed in the Supreme Court. On October 28, 2001, Bezeq International filed an application to strike the appeal *in limine*. The parties filed their summations. In a hearing in the Supreme Court on July 15, 2003, the Supreme Court explained that the District Court had erred procedurally, since it should have decided only on the application to join another plaintiff to the class action and not on the question of denial of the application for approval of the claim as a class action. Accordingly, the appeal was allowed. The case was returned to the District Court and instead of a hearing, the plaintiff's summations were filed on May 16, 2004, and on January 2, 2005, Bezeq International filed its summations on the question of approval of the claim as a class action and on the question of establishment of the plaintiffs' personal cause of action. On November 22, 2005, the District Court dismissed the application for approval of the claim as a class action, adopting the ruling of the court in the earlier decision to dismiss the application, and added that the application should also be dismissed due to the fact that the applicant had no personal cause of action. On January 15, 2006 the applicant filed notice of appeal in the Supreme Court. The legal advisers of Bezeq International believe that Bezeq International has a reasonable chance of the applicant's appeal being in the Supreme Court will be dismissed, which will bring the proceeding to an end. Accordingly, Bezeq International decided not to include a provision in respect of this claim in the financial statements.

(24) On September 16, 2001, a revised statement of claim and an application for recognition as a class action were filed against Bezeq International and the State of Israel. The plaintiff alleges that the tariffs for international telecommunication services during the period from May 10, 1996 to July 8, 1997, were exorbitant and unreasonable, and abused the status of Bezeq International as a monopoly, against a backdrop of falling prices as the international calls market was opening up to competition. On February 18, 2002, Bezeq International filed its response in the court, in which it rejected the allegations of the plaintiff and alleged that the conditions for allowing the claim as a class action had not been established. The Court allowed the request of the applicant to study the financial statements of Bezeq International for the relevant period and the minutes of the meetings of its board of directors from the same period. On December 25, 2003, the court allowed the application by virtue of the Antitrust Law and not on the basis of a cause arising from the Unjust Enrichment Law, and approved the claim as a class action. On January 14, 2004, the daily press included an item about the decision to approve the claim as a class action under Chapter F of the Antitrust Law. On January 15, 2004, an application was filed in the District Court for a stay of implementation of the decision. On February 2, 2004, the plaintiff filed its reply to the application, requesting its dismissal *in limine.* On the same date, the plaintiff filed an appeal in the Supreme Court against the decision of the District Court relating to the cause prescribed in the Unjust Enrichment Law. At the request of the State and Bezeq International, in February 2004 the District Court agreed to delay implementation of its decision on approval of the claim as a class action pending the decision of the Supreme Court on the application for leave to appeal filed by Bezeq International (see below).

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(24) (contd.)

Following applications for leave to appeal filed by the State and Bezeq International in the Supreme Court on this matter, the Supreme Court determined, on March 7, 2004, that their applications must be answered, and accordingly, on May 9, 2004 the plaintiff filed its reply to the applications of Bezeq International and the State for leave to appeal. The hearing of the class action and the two applications for leave to appeal were consolidated into one case, the parties filed their summations, and the Court scheduled a hearing to complete the arguments orally on April 4, 2006.

The Company believes, based on the assessment of Bezeq International and its legal advisers, that if the action is eventually approved also by the Supreme Court as a class action and if it is allowed, the amount of the action is liable to reach hundreds of millions of shekels. However, the legal advisers of Bezeq International estimate that Bezeq International has good arguments against the decision of the District Court, and that there is a good change that Bezeq International's application for leave to appeal will be allowed and that the decision of the District Court will be set aside. Accordingly, Bezeq International decided not to include a provision in respect of this claim in the financial statements.

(25) On March 3, 2003, a claim was filed against Bezeq International by a systems vendor for approximately NIS 18.5 million. According to the vendor, Bezeq International unlawfully canceled an agreement to supply and install a customer care and billing system, and it is suing for enforcement of the agreement with Bezeq International and compensation for the losses deriving from the delay in the project, and alternatively – if the claim for enforcement is not allowed – compensation in respect of all the losses it sustained as a result of breach of the contract. On May 26, 2003, Bezeq International filed a statement of defense and a statement of counter-claim in the amount of NIS 10 million, in which it alleged that the contract was canceled because the vendor violated the undertakings it made in the contract. On September 14, 2003, the vendor filed a reply to the counter-claim, in which it denied the allegations of Bezeq International. At the request of the vendor on January 20, 2004, that a date for the pre-trial hearing be set, the Court recommended that the parties use the time until the pre-trial hearing for a mediation proceeding. The parties conducted settlement negotiations, and there is agreement in principle which needs to be formalized. It was agreed that the principles would be formalized in the mediation proceeding before an agreed mediator. The legal advisers of Bezeq International are unable, at this stage, to estimate the chances of the outcome of the claim or the mediation proceeding, but clearly, the amount of the settlement at which the parties intend to arrive is not material, and accordingly, the management of Bezeq International decided not to include a provision in the financial statements.

(26) In December 2000 a claim was filed in the Tel Aviv-Jaffa District Court against Pelephone by the State of Israel, for royalties allegedly payable for the period from January 1994 to February 1996. The amount claimed is estimated at approximately NIS 260 million (including principal, linkage differentials and interest).

In the opinion of Pelephone's management, relying on the opinion of its external legal advisers who are handling the claim, Pelephone has a good defense against the claim, the amount of which is apparently highly exaggerated. Pelephone's financial statements include a provision which the management believes is appropriate, and will suffice if indeed Pelephone is required to pay any amount in the claim / mediation proceeding.

On March 11, 2001, Pelephone filed a statement of defense and a statement of counter-claim relating to the State's claim for payment of royalties for the period January 1, 1994 to February 7, 1996. In its counter-claim, Pelephone claims reimbursement of approximately NIS 66 million (principal, interest and linkage up to March 1, 2001) in respect of an advance it paid to the State as a goodwill gesture in order to arrive at a settlement arrangement in 1996, a payment which was made contingent upon the State not suing Pelephone for reason of royalties.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(26) (contd.)

Before a hearing was held, the parties reached an agreement to transfer the matter to a mediation proceeding, which commenced in 2002 and during which an outside examiner was appointed to check the revenue components on which royalties are payable for the period of the claim and which affect the amount of the original claim. The results of that examination were submitted in September 2004, and found that the maximum amount of royalties on the revenues of Pelephone from January 1, 1994 to February 7, 1996 is only approximately NIS 118 million (before interest and linkage), of which approximately NIS 23 million relate to the period January – October 1994. The sum of NIS 46 million (before interest and linkage differentials) was paid as aforesaid in 1996 out of a desire to reach a settlement. The mediation proceeding has ended. The parties have reached agreement in principle concerning the statement of claim, but no agreement has yet been reached regarding the final text.

On February 16, 2004, the Company provided an undertaking to Pelephone, as approved by the Board of Directors on February 12, 2004, that if the mediation proceeding fails, the Company will pay Pelephone any sum it is ordered to pay to the State, if charged in a peremptory decision in respect of royalties for revenues from the provision of cellular services during the period from January 1, 1994 to October 10, 1994. According to the Company, it paid the State for that period under the settlement agreement between it and the State dated November 29, 1995. The undertaking to indemnify is subject to the presentation of the Company's arguments in the proceeding and the consent of Pelephone for the Company to join the action as a third party should the Company request to do so. The Company estimates that the risk of it being ordered to pay is low, and accordingly, no provision has been made in its financial statements.

(27) In July 2001 a claim was filed in the Tel Aviv-Jaffa District Court against Pelephone. The plaintiffs allege that Pelephone's pre-paid service constitutes infringement of a patent of the plaintiff's company. Among the reliefs claimed are that Pelephone be directed to cease and desist from infringing the patent, be ordered to submit a report on the number of cards, revenues and profits, etc., received in respect of the sale of the cards, and ordered to pay NIS 100,000 in compensation. The Registrar of Patents recently gave his decision on the matter of cancellation of the patent, determining that the patent is not worthy of registration. The date for filing an appeal against the Registrar of Patents decision has already elapsed.

(28) In September 2001 a claim was filed in the Ramallah District Court by the General Palestinian Public Communications Co. Ltd. ("Paltel"), against Pelephone and another company.

The plaintiff alleges that its license grants it, *inter alia*, the full right and authority to set up, operate, supply, sell and manage services and stations for telephone communication, both landline and cellular, for the supply of fixed and cellular communications services for an extended period, part of which being granted exclusivity. According to the plaintiff, it commenced providing cellular communications services in September 1999, and despite its requests to the defendants, they are continuing to provide cellular communications services to the inhabitants of the West Bank and the Gaza Strip, without restraint and without a license from the Palestinian communications authority, thereby violating various provisions of the law, prejudicing the exclusive rights of the plaintiff and causing it losses and damages. The reliefs requested are a permanent judicial injunction preventing the defendants from providing communications services in the areas of the Palestinian National Authority and a financial action for NIS 676 million from Pelephone alone.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(28) (contd.)

As at the date of signing these financial statements, the process of transferring the claim through the Attorney General has ceased and the alternative process of delivery effected by registered mail has been returned through the Ministry of Justice, and therefore this claim is not counted among the claims currently pending against Pelephone. It should also be noted that Pelephone does not recognize the jurisdiction of the court in Ramallah.

Pelephone learned that the Ramallah Court may have given a decision on the aforementioned claim. According to the Emergency Order (Judea, Samaria and the Gaza Strip – Jurisdiction in offenses and legal aid) (Territories of the Palestinian Authority – Legal aid in civil matters), 5759-1999, enforcement of decisions given by a court of the Palestinian Authority may only be executed if approved by the Commissioner for Legal Aid at the Ministry of Justice. Pelephone considers that such a ruling – if made – was made without jurisdiction, contrary to public order and contrary to the provisions of the interim agreement and the Extension of the Effect of the State of Emergency Regulations Law (Judea, Samaria and Gaza Strip – Jurisdiction in offenses and legal aid) 5727-1967. If an attempt is made to submit this ruling for the approval of the Commissioner or to enforce it in any way, Pelephone will act to prevent such approval and/or enforcement of the ruling and/or proceedings for execution or to cancel them for the reasons set out above, which formed the basis of the Commissioner's decision to prevent the claim being served on Pelephone in the first place, and additionally due to the fact that the very hearing of the claim in the Ramallah Court without the process having been served in accordance with the Order and the Agreement, constitutes a breach of the Agreement and harm to the sovereignty of the State of Israel, and that any ruling handed down in such a claim has no force. Accordingly, no provision in respect of this claim has been included in the financial statements.

(29) In November 2002 an application was filed for leave to appeal the decision of the Tel Aviv-Jaffa District Court from October 1, 2002, to dismiss the application of the applicants for approval of their claim against Pelephone as a class action. The statement of claim was based on the applicants' allegation that throughout the years when Pelephone was a monopoly in the cellular telephone market, it abused that status and collected exorbitant prices for all its services. The applicants were therefore seeking to order Pelephone to make restitution to its customers of the excess profits it collected and which allegedly total the amount of the claim (NIS 12.3 billion). On February 2, 2003, Pelephone responded to the application for leave to appeal. In the opinion of Pelephone and its legal advisers, Pelephone has good defense arguments, although the chances of the appeal cannot be assessed at this stage, and accordingly, no provision has been made in the financial statements in respect of this claim.

(30) In December 2002 a claim was filed in the Tel Aviv-Jaffa District Court against Pelephone and against another cellular company, together with an application for its approval as a class action, in the amount of approximately NIS 4 billion, of which approximately NIS 2.4 billion is against Pelephone.

The claim relates to amounts collected by Pelephone and another cellular company for incoming calls from May 5, 1996 to October 2, 2000. The applicants, through their lawyers, base their claim on the following allegations:

a. Every cellular operator is a monopoly in the incoming call service to its network. Pelephone and the other cellular operator abused their monopoly status in that they set high and unfair prices for the incoming call service to their networks. The correct and fair tariff for the incoming call service is 25 agorot per minute, and not as collected in the past by Pelephone and the other cellular company or as stipulated today in the Telecommunications Regulations (Payments for interconnect), 5760-2000.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(30) (contd.)

b. Pelephone and the other cellular company violated obligations legislated under the authority of the Telecommunications Law, their licenses and the duty of good faith which require a reasonable price for a telecommunications service for which no price is set.

In July 2003 Pelephone filed its response to the application. Pelephone and its legal advisers believe that Pelephone has a good defense, but are nevertheless unable, at this stage, to estimate the chances of the claim. Accordingly, no provision was made in the financial statements in respect of this claim.

(31) In April 2003 an application was filed in the Tel Aviv-Jaffa District Court for approval of a class action in a total amount of approximately NIS 90 million against all the cellular companies. The applicants allege that the three cellular companies formed a cartel among themselves for the collection of a tariff of 38 agorot plus VAT for SMS messages coming in to the network of each of them. The plaintiffs allege that this is a uniform, coordinated, exaggerated, unreasonable and unfair tariff. The period to which the claim relates is from March-June 2002 through the date of filing the claim. Pelephone believes, relying on its legal advisers, that it has good arguments for defense against the claim, however at this stage, its chances cannot be assessed. Accordingly, no provision has been made in the financial statements in respect of this claim.

(32) On May 13, 2004, a petition was filed in the High Court of Justice by the municipalities and local planning and building committees in Herzliya and Ramat Hasharon against the Government of Israel, the National Planning and Building Council, the Minister of Health, the Interior Ministry, the head of the Noise and Radiation Abatement Department at the Ministry of the Environment, the Attorney General, the Future Generations Commissioner and the cellular companies, among them Pelephone. The petition attacks the provisions of the National Outline Plan for Small Communications Installations, Part A (NOP 36), its legality and the manner of its implementation in the field. The petition was heard on July 5, 2004, at which time the High Court of Justice ruled to postpone the hearing to a later date and to rule on continuing the proceedings in the light of a supplementary notice to be submitted by the State Attorney's office within three to four months. During 2005, the petitioner filed an application to withdraw the petition and the petition was struck out.

(33) In August 2005 a claim was filed against the Government of Israel, the National Council, the Ministry of the Interior, the head of the Noise and Radiation Abatement Division (at the Ministry of the Environment), the cellular companies, including Pelephone, and a company named Elidav – Building & Investments Co. Ltd. (the owner of a house in Ramat Hasharon on the roof of which cellular antennae were installed). The claim concerns the liability for claims under Section 197 of the Planning and Construction Law for the issue of building permits for cellular antennae. The central allegation in the claim, as far as the cellular companies are concerned, is that in the proceedings for approval of National Outline Plan 36A, the cellular companies undertook to indemnify the local committees in respect of compensation those committees would be ordered to pay in claims under the aforementioned Section 197, and that the National Outline Plan was approved on the basis of that undertaking. According to the plaintiffs, the undertaking is tantamount to "a contract in favor of a third party" in their favor and in favor of the other local committees.
The plaintiffs also allege that the Government and the National Council were negligent in that they did not anchor that undertaking in the National Outline Plan, and once it transpired – after approval of the Plan – that the cellular companies were unwilling to indemnify the local committees, the Government and the National Council should have cancelled or suspended the Plan and should also have cancelled the franchises of the cellular companies.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(33) (contd.)

The plaintiffs are petitioning for a large number of reliefs (about 20), all declaratory. The principal reliefs are to declare that the cellular companies and the other defendants must pay the compensation ruled against the local committees in claims under the aforementioned Section 197. In the opinion of Pelephone, relying on its legal advisers, the chances of the claim are poor, and accordingly, a provision is not included in respect of this claim in the financial statements.

(34) In October 2005 Pelephone received notice of the filing of an application to add Pelephone to the proceeding of an appeal filed by the owners of rights in land adjoining a cellular communications site operated by Pelephone and others in Ramat Gan. The appeal was filed against a decision of the local committee in Ramat Gan to reject a claim submitted to it in respect of impairment of value by virtue of Section 197 of the Planning and Construction Law, by the owners of those rights. The amount of the claim is approximately NIS 100 million. The notice also stated that the local committee was making the application since it believes that Pelephone is liable for any damage caused as a result of the communications installation, and is one of those who must indemnify it for any damages it incurs as a result of the claim/appeal being allowed. A decision on joining Pelephone has not yet been made
The proceeding is being studied by Pelephone, which intends to oppose it in its entirety. Pelephone believes, relying on its legal advisers, that at this stage of the proceeding there is no exposure for Pelephone. No decision has been given on the application as yet.

(35) On February 12, 2006, a claim together with an application for its recognition as a class action was filed against Pelephone, concerning payments collected by Pelephone for transferring calls from Bezeq's 144 service to the requested destination (call transfer). The plaintiff alleges that Pelephone unlawfully collected 53 agorot for each call transfer. The total amount of the claim (which relates to the three years prior to the date of its filing) is estimated by the plaintiff at NIS 33.5 million.

Pelephone is studying the claim and is unable and/or the Company is unable, at this stage, to assess its chances. It is noted even before examining the claim itself, that from its examination of the sums of money relevant to the action, Pelephone believes that even if the claim is allowed in its full amount, its financial exposure is not material.

(36) On December 3, 2002, an application was filed in the Tel Aviv-Jaffa District Court for recognition of a claim as a class action against DBS, the Council for Cable and Satellite Broadcasts and the Ministry of Communications, in connection with the broadcasts of the Channel 5+ sports channel. According to the applicants, the broadcasts of Channel 5+ contravene the terms laid down in the approval issued by the Council for its broadcasting while stripping Channel 5 of its content, in contravention of the aforementioned approval. The applicants, who wish to sue DBS for deception, violation of fiduciary duty and good faith under a contracted agreement, fundamental breach of the contract between DBS and its customers and unjust enrichment, estimated the amount of the claim at approximately NIS 126 million up to the date of its filing and an additional amount of approximately NIS 10.5 million for each month from the date of filing the claim until the date on which the decision is handed down. On July 25, the court allowed the application of DBS to stay the proceedings, pending the decision in the application for approval which was filed on the same matter against the cable companies.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(36) (contd.)

On December 13, 2005, the Consumer Protection Law was amended in a way that enables class actions to be filed in connection with circumstances which came into being after the date of making a commitment in a transaction, and it was determined that the amend would apply also to claims filed before the application of the law, provided that a final decision had not yet been given. On January 9, 2006, a decision was given on an appeal in the matter of the cable companies setting aside the decision of the District Court to deny the application against them. On January 29, 2006, an application was filed to amend the application for approval, in view of the amendment to the provisions of the Consumer Protection Law , as well as an application for direction for the matter of further stay of the proceedings pending a new decision on the application filed against the cable companies.

The legal advisers of DBS believe that it is difficult, at this stage, to estimate the chances of the claim, and accordingly, no provision has been included in respect of this claim in the financial statements.

(37) On February 21, 2005, an application was filed in the Tel Aviv-Jaffa District Court against DBS, concerning payment the plaintiff makes to cover the electricity consumption of installations used to receive DBS's broadcasts. Together with the claim, an application was filed in the court for its approval as a class action, since it concerns thousands of condominiums in which DBS's equipment is installed and which pay for the consumption of electricity of those installations.

According to the plaintiff, about 200,000 households pay a monthly charge of NIS 1.4, from which he concludes that since the start of its operation (which the plaintiff contends is 6 years), DBS should be ordered to pay approximately NIS 20 million. On April 28, 2005, the parties filed an agreed application to strike the action and an application to approve it as a class action without an order to pay costs. On May 1, 2005, the claim and the application for approval were stricken without an order to pay costs.

(38) In 2001 the Ministry of Communications issued administrative directives which regulate how a subscriber switches from the services of the cable companies to DBS and vice versa, and the use of infrastructures in the subscriber's home. The directives also prescribe a duty to pay monthly usage fees for infrastructure owned by the other multi-channel television service provider. Since the administrative directives were issued, DBS and the cable companies have submitted mutual complaints of violation of the directives by the other party, and voluminous correspondence has been exchanged between DBS and the Ministry of Communications on the matter. On August 15, 2005, the Ministry of Communications notified DBS and the cable companies that in view of their numerous violations of the administrative directives, it had re-examined the matter and was now considering their cancellation, *inter alia*, in view of the mechanism for purchasing the wiring prescribed in the Communications Law, which enables a subscriber to purchase the wiring in his home for NIS 120.

On November 2, 2005, DBS submitted its position to the Ministry of Communications, stating that the administrative directives should remain in place, while canceling the early notice prescribed in them, which requires that notice be given to a party whose subscribers disconnect from its services. DBS also contended that the provisions of the law granting ownership of infrastructure to the multi-channel television provider that installs it in the homes of its subscribers. At the very least, contended DBS, if that directive remains in place, its proper interpretation should not grant the cable companies ownership of the wiring it installed in private houses. DBS also stated that the amount prescribed in the law as the consideration to be paid for purchasing the wiring (NIS 120) is baseless and that if the directive is retained, the amount should be considerably reduced.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(39) On December 29, 2005, an application was filed in the Tel Aviv-Jaffa District Court for approval of a claim against DBS as a class action. The reliefs applied for are as follows:

a. Monetary compensation for every customer who entered into an agreement with DBS by telephone and not in writing (leaving the amount to the discretion of the court. In the plaintiff's personal claim, he requests NIS 20,000 in compensation).

b. Monetary compensation in the amount allowed against him, for whoever actually paid more than the amount agreed upon with him by telephone by representatives of DBS's service.

c. A declaratory order to DBS determining that from now on, whoever enters into an agreement with it by telephone will receive the arrangement in writing within 21 days.

In the opinion of the legal advisers of DBS, it is difficult, at this stage, to assess the chances of the claim, and accordingly, no provision has been included for this claim in the financial statements.

(40) **The "industrial espionage" affair**

On May 29, 2005, the media published a news item stating that the Government of Israel is conducting an investigation into "industrial espionage" by computerized means (a "Trojan horse" program), in which it was stated that the Company's subsidiaries Pelephone, Bezeq International and DBS, were involved:

a. On May 31, 2005, the cable companies ("HOT") filed an *ex parte* application ("the First Application") in the Tel Aviv-Jaffa District Court, in which the court was requested to grant, *inter alia*, an order for the appointment of a receiver, who would be authorized to search and seize commercial secrets of HOT at all the sites operated by DBS and other information of HOT which is confidential or lawfully concealed, as well as other temporary reliefs, mainly to forbid DBS from making use of the commercial secrets of HOT.

The background to the application filed by HOT was newspaper articles about the "industrial espionage" affair conducted by means of Trojan horse software, where according to HOT, DBS appears to have acted illegally, through the Modi'in Ezrachi private investigations firm with which it had signed an agreement, so as to enable it to obtain confidential information of HOT while perpetrating the tort of commercial robbery.

After dismissal of its application, HOT filed a "revised" *ex parte* application ("the Second Application"), in which it repeated its request, this time stating that its allegations are not based solely on reports in the media as it alleged in the First Application, but also on information conveyed to it by police investigators. At the same time HOT also filed a statement of claim against DBS, which does not include an application for any financial relief and in which the court was requested to grant various declaratory reliefs and mandamuses and injunctions to prohibit DBS from making use of HOT's commercial secrets.

In its response to the application, DBS rejected the allegations of HOT and stated that without waiving any of its allegations, it is willing to undertake to refrain from making any use of documents relating to the business of HOT which it received from Modi'in Ezrachi, and that if any such document or information is found, that document will be placed, as is, in an envelope and stored in the safe. In a hearing held on July 7, 2005, and with the consent of the parties, the court made a decision to validate DBS's notice not to make any use of documents and information conveyed to DBS by Modi'in Ezrachi. In this way, the court in fact dismissed the applications of HOT for the appointment of a receiver and for a temporary injunction of broader scope than the undertaking made by DBS.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(40) a. (contd.)

On June 30, 2005, DBS, filed a statement of defense in the court, in which it denies the allegations made by HOT in the statement of claim. No date has been scheduled as yet for hearing the claim. On July 12, 2005, HOT filed an application to split reliefs, so as to enable it to file a financial claim against DBS in a separate claim. On September 18, 2005, DBS filed its response in an application to dismiss HOT's application. No decision has been given on the application. DBS believes, relying on its legal advisers and noting the fact no financial claim has yet been filed, the fact that no decision has yet been given on the application to split reliefs and the novelty and complexity of the legal questions arising in the claim, that at this stage the chances of the outcome of the claim cannot be estimated.

b. On May 31, 2005, three employees of Bezeq International were called in for questioning as part of the police investigation of the industrial espionage by computer (a Trojan horse program). After being questioned, the employees were released under restriction. Up to the date of publication of these financial statements, no action has been taken against Bezeq International and/or its employees which relates to the aforementioned investigation.

c. In November 2005 a claim was filed in the Tel Aviv-Jaffa District Court against Pelephone and against Modi'in Ezrachi, for an order to report, together with an application to split reliefs. The grounds for the claim revolved around allegations that Pelephone had ostensibly solicited business information about the plaintiff's business and this was supplied by Modi'in Ezrachi by violating a number of provisions of the law and as part of a Trojan horse affair. A statement of defense had not yet been filed. In the opinion of Pelephone, relying on its legal advisers, the action in its present format and the reliefs included in it have little chance of success, and therefore no provision has been made in respect of this claim in the financial statements.

It should be noted that a number of senior employees of the Company were called in for questioning by the police immediately after publication of the affair, regarding confidential documents of the Company which were found on the premises of competing entities and to assess the extent of the harm which the Company could expect as a result. The Company examined the matter and took immediate action to minimize as far as possible the risk of the removal of information from the Company.

(41) In 1995 the Company, together with others and by means of a joint company, competed for tenders issued by the Government of India for the establishment of a basic communications system in India. Letters of intent and draft franchise agreements for development of the basic telephone system in four regions, which were won by the joint company in which the Company has a stake, were sent to the joint company, which did not sign them since, *inter alia*, it found that the drafts did not correspond to the terms of the tender. When submitting its bid in the tender, the joint company provided the Ministry of Communications in India with bank guarantees, in which the Company's share is 273 million rupees (approximately NIS 26 million). The Indian Ministry of Communications demanded foreclosure of the guarantees at the end of June 1996. On September 19, 1997, the court in India gave a permanent injunction preventing the Indian Ministry of Communications from foreclosing on the guarantees. At the end of October 1997 the Indian Ministry of Communications appealed the decision preventing the foreclosure. During 2003 the proceeding was struck out for "inaction" and an application was filed to revive it. The appeal is scheduled for May 21, 2006. The Company requested that the Indian Ministry of Communications release the guarantees it was holding (the subject of the appeal) and return them to the Company. A reply to the request has not yet been received. The Indian lawyer who is handling the case on behalf of the Company believes that since the proceeding is still in its preliminary stages, its outcome cannot reasonably be foreseen with any accuracy. Accordingly, the financial statements do not include a provision for this case. It should be noted that the Company currently has no operations in India.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(42) For possible demand for early repayment of bank loans, see Notes 13D and 14C.

(43) Miscellaneous claims - Various claims are pending against the Company and the Group Companies arising from the normal course of business. It is the opinion of the companies' Managements that the latent risk in each of these claims will not cause material financial losses beyond the amounts included in the financial statements.

The amounts of the claims referred to above are adjusted (without the addition of interest) in terms of shekels of December 31, 2005.

B. COMMITMENTS

(1) Lease and Rental Contract Commitments

Forecast contractual rent for the coming five years computed according to the rent in effect on December 31, as follows:

	Consolidated	Company
For the year ended December 31	**NIS thousands**	**NIS thousands**
2006	**218,648**	**62,967**
2007	**184,535**	**61,943**
2008	**137,621**	**56,529**
2009	**75,363**	**21,453**
2010 and thereafter	**173,135**	**98,865**
	789,302	**301,757**

(2) As at December 31, 2005, DBS is committed to agreements to purchase broadcasting rights which amount to approximately NIS 139 million.

(3) DBS entered into an agreement to lease space segments of the Amos 1 satellite. The agreement commenced on April 14, 1999 and ends on the earlier of June 30, 2009 or the end of the life of the satellite. In addition, DBS entered into an agreement on May 16, 2001, to lease space segments on the Amos 2 satellite. The lease period will end on the earlier of twelve years after the date of the satellite's launch or at the end of the satellite's life. The satellite was launched in April 2004. The contractual annual lease fees during the next five years as stated in the aforementioned agreements, amount to NIS 621 million.

(4) Under the license and the rules set by the Cable and Satellite Broadcasts Council, in 2006 and 2007 DBS will be required to invest not less than 8% of its revenues from subscriber fees in locally produced content broadcasts.

(5) As at December 31, 2005, DBS is signatory to a number of agreement for acquiring purchased channels. In the year ended December 31, 2005, the expenses in respect of consumption of purchased channels amounted to approximately NIS 173 million.

(6) In winning a tender for frequencies, Pelephone committed to paying license fees in the amount of NIS 225 million to the Ministry of Communications in six installments through 2006 (see Note 8D2).

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

B. COMMITMENTS (CONTD.)

On March 16, 2004, Pelephone accepted the proposal of the Ministries of Communications and Finance concerning a reduction of NIS 33 million from the original payment stipulated in the frequency band tender, against –

a. payment of the remainder of the balance of the license fee in the amount of approximately NIS 99 million, during 2004; and
b. return of the aforementioned frequencies to the State, in order that that Pelephone will not have to pay frequency fees from 2003 onwards. In addition and concurrently, Pelephone was granted a right to a future allocation of these frequencies, at which time Pelephone would complete payment of the reduced amount, plus the frequency fees in respect of the relevant period, and all plus linkage differentials and interest as is customary

Between March and August 2004 Pelephone paid the balance of the license fees – approximately NIS 99 million.

On May 4, 2004, Pelephone received a letter from the Ministry of Communications, advising that according to an amended calculation made by the Ministries of Finance and Communications, the amount that Pelephone will be required to pay at the time of allocation of the frequencies in the future, is NIS 51 million rather than NIS 33 million as agreed in March 2004. Pelephone has not submitted its position to the Ministries.

As at the date of publication of these financial statements Pelephone, based on an assessment of its technological and business requirements, has not changed its assessment regarding the need to utilize the future rights to frequencies.

(7) In May 2004 Pelephone signed an agreement for upgrading sites with EVDO technology. The contract value is approximately $44 million, and the upgrade will be carried out during 2004-2007. In March 2005 Pelephone signed an agreement with the same supplier for additional sites, in order to increase the coverage and capacity of Network 1X. The contract value is approximately $20 million.

(8) In January 2005 Pelephone won a tender issued by the Accountant General at the Ministry of Finance ("the AG"), to provide cellular services to the various government ministries for a period of three years, commencing April 2005. The tender includes an option for the AG to extend the agreement for a further three years. Under the agreement, Pelephone supplied cellular subscriber equipment to about 30,000 subscribers. The costs of acquiring the subscribers in the AG transaction, approximately NIS 30 million in respect of the supply of subscriber equipment, was charged to the statement of operations in 2005.

(9) In February 2004 Bezeq International entered into an agreement with Mediterranean Nautilus Limited ("Med Nautilus") for acquisition of an irrevocable right of use of undersea cable capacity. In addition, the agreement grants Bezeq International options for an additional purchase of an irrevocable right of use of undersea cable capacity from Med Nautilus. Some of the options were exercised during 2004, and the others will be exercised over a period of one year commencing June 2006.

(10) For commitments to purchase fixed assets, see Note 9E.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

C. SECURITIES, LIENS AND GUARANTEES

(1) The Company has provided guarantees to third parties in the amount of approximately NIS 2,652 thousand.

(2) In May 2003, the Company, upon the demand of the Ministry of Communications, provided a bank guarantee in the amount of $10 million in connection with its general license for performing telecommunications operations and providing telecommunications services. On June 22, 2005, the Company received a letter from the Director General of the Ministry of Communications, containing notice of the Ministry's decision to call in NIS 10 million out of the $10 million bank guarantee provided by the Company as aforesaid. According to the Director General's letter, the decision to foreclose was made in light of the fact that the Company made a commitment to the institutional investors who extended loans to DBS, in which the Company holds 49.8% of the share capital, which contravened the directives of the Minister of Communications.

It should be noted that since the decision of the Minister of Communications to impose limitations and conditions on the transfer of funds by the Company to DBS, both DBS and the Company have acted, irrespective of their legal position concerning the authority of the Minister of Communications to intervene in the matter of the financing of DBS by shareholders and other financing bodies, to comply with the conditions and limitations imposed by the Minister and by the Antitrust Commissioner, concurrently with legal proceedings which they instituted in the High Court of Justice and in the Antitrust Court (see Note 8 above). The Company's position is that there is neither legal nor any other basis for calling in part of the guarantee of which the Director General gave notice, and therefore no provision was included in the financial statements. An appeal against the decision was submitted to the Minister of Communications, and implementation of the foreclosure has been frozen pending a decision on the appeal. As noted in Note 8E above, the petitions of the Company and DBS against the Minister of Communications in the High Court of Justice were heard on October 11, 2005, but the Court has not yet handed down its ruling.

(3) The Company provided a guarantee amounting to up to NIS 70 million to banks in connection with credit granted to subsidiaries.

(4) Regarding guarantees provided by the Company with regard to its investments in India, see Note 19A(41).

(5) The Company provided a guarantee of approximately NIS 10 million for DBS, in respect of a bank guarantee of approximately NIS 33 million that DBS provided in favor of the State of Israel. The guarantee is valid until December 31, 2010.

(6) In February 2002, upon the demand of the Ministry of Communications, Bezeq International provided a bank guarantee of NIS 10.6 million for fulfillment of all the terms of the license to provide international telecommunications services. In December 2004, again at the demand of the Ministry of Communications, Bezeq International provided a bank guarantee of approximately NIS 320,000 for fulfillment of the terms of a special license granted to Bezeq International for a VOB service marketing trial. As at the balance sheet date, Bezeq International provided additional bank guarantees in a total amount of approximately NIS 2.3 million.

(7) BezeqCall Communications provided a guarantee of approximately NIS 4 million for third parties

(8) Pelephone provided a guarantee to third parties of approximately NIS 78 million, of which approximately NIS 46 million to the Ministry of Communications in connection with the tender for third generation frequencies for cellular telephones.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

C. SECURITIES, LIENS AND GUARANTEES

(9) To secure its obligations, DBS provided documentary credit and guarantees amounting to approximately NIS 54 million (including a bank guarantee of NIS 33 million in favor of the State of Israel).

(10) Regarding three loan agreements signed between DBS and various institutional bodies in March-April 2005, for a total amount of NIS 50 million with an option to extend additional loans for a total amount of NIS 50 million as described in Note 8E above, the Company undertook that if (all or part) of the loans are not repaid on time, or if certain other conditions exist (if an final injunction is given by a court of law or if a valid decision is made to liquidate DBS, if a receiver is appointed for DBS and/or on all or a material part of its assets, in any case where the guarantee provided to the Banks is called in or realized, if the Company sells all its holdings in DBS, and in respect of a loan to one institutional body – if control of the Company is transferred from the State to another and as long as six months have not elapsed from the date of actual transfer of control to the date of the lender's notice), the lenders will be able to demand that the Company repay the lower of the balance of the loans (principal, interest and linkage differentials) and an amount computed according to a predetermined formula which takes into account the value of DBS at that time.

(11) Regarding another guarantee provided in connection with the Company's investments in DBS, see Note 8E.

(12) Regarding securities, liens and stipulations given by the Company and investee companies in connection with loan covenants, see Notes 13D and 14C.

(13) Regarding loans which the lenders may call for immediate repayment, see Note 1F.

NOTE 20 – SHAREHOLDERS' EQUITY

A. SHARE CAPITAL

	Registered		**Issued and fully paid up**	
	December 31 2005	**December 31 2004**	**December 31 2005**	**December 31 2004**
	No. of shares	**No. of shares**	**No. of shares**	**No. of shares**
Ordinary shares of NIS 1 par value each	**2,625,000,000**	2,625,000,000	**2,605,045,611**	2,605,045,611

B. On June 1, 2004 the State of Israel offered, pursuant to a prospectus of the Company of May 24, 2004, 156,000,000 ordinary shares of NIS 1 par value each of the Company (approximately 5.99% of the Company's issued capital). In the public offering, 70,671,100 ordinary shares of NIS 1 par value each were sold (approximately 2.71% of the Company's issued capital) at a price of NIS 4.921 per share, and the State's holdings in the Company as at December 31, 2004 were approximately 46.38%. Following the closing of the sale of 30% of the State's shares in the Company to Ap.Sb.Ar. (see also Note 1F above), on October 11, 2005 the State's holdings in the Company decreased to 16.38%.

C. On January 27, 2003, the Special General Meeting of the Company approved the recommendation of the Board of Directors of January 2, 2003, for the distribution of a cash dividend to holders of Company shares recorded in the Register of Shareholders at the end of the business day on February 5, 2003. The ex-date was February 6, 2003, and the date of payment was February 20, 2003. The cash dividend, amounting to approximately NIS 190,000 thousand, represents a dividend of 7.8784 agorot per share.

D. On the matter of a dividend of NIS 1,200 million announced after the balance sheet date, see Note 1H.

NOTE 21 – REVENUES FROM TELECOMMUNICATION SERVICES

Consolidated

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Revenues from communications services –			
Traffic	**1,436,615**	1,567,631	1,990,649
Fixed fees	**2,559,559**	2,501,250	2,289,868
	3,996,174	4,068,881	4,280,517
Cellular telephone	**3,643,795**	2,699,876	1,989,970
International communications and internet services	**775,532**	771,290	683,037
Multi-channel television	**1,171,318**	529,838	-
Installation, sale of equipment to subscribers, and other	**1,246,947**	914,838	665,717
	10,833,766	8,984,723	7,619,241
Other revenues	**264,920**	285,081	362,027
	11,098,686	9,269,804	7,981,268

Company

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Revenues from communications services –			
Fixed–line communications			
Traffic	**1,460,076**	1,590,671	2,006,567
Fixed fees	**2,404,970**	2,354,700	2,184,650
Total revenues from fixed-line communications	**3,865,046**	3,945,371	4,191,217
Cellular telephone	**370,706**	414,740	428,149
International communications	**109,207**	126,856	134,212
Installation, sale of equipment to subscribers, and other	**167,904**	266,980	224,443
	4,512,863	4,753,947	4,978,021
Other revenues	**210,871**	205,744	252,540
	4,723,734	4,959,691	5,230,561

NOTE 22 – OPERATING AND GENERAL EXPENSES

Consolidated

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Salaries and related expenses –			
Operational	**1,794,458**	1,578,426	1,648,413
General and administrative	**684,290**	549,869	304,465
Total salaries and incidentals	**2,478,748**	2,128,295	1,952,878
General expenses	**1,209,169**	996,323	733,412
Materials and spare parts	**1,016,735**	643,013	597,676
Consumption of content from satellite services	**419,309**	200,469	-
Cellular telephone expenses	**991,066**	700,890	480,536
Building maintenance	**366,630**	352,430	352,405
Services and maintenance by sub-contractors	**422,416**	341,999	250,220
International communications expenses	**277,210**	228,936	159,478
Motor vehicle maintenance expenses	**181,385**	144,630	118,050
Collection fees	**49,196**	39,357	36,160
	7,411,864	5,776,342	4,680,815
Less – wages charged to investment in fixed assets (1)	**218,396**	211,252	195,515
	7,193,468	5,565,090	4,485,300

Company

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Salaries and related expenses			
Operational	**1,140,482**	1,122,381	1,206,623
General and administrative	**288,804**	271,310	241,206
Total salaries and incidentals	**1,429,286**	1,393,691	1,447,829
General expenses	**298,767**	341,977	342,492
Materials and spare parts	**97,294**	114,443	93,601
Building maintenance	**320,700**	315,074	322,099
Services and maintenance by sub–contractors	**195,820**	205,192	207,843
International communications expenses	**30,033**	27,105	10,685
Motor vehicle maintenance expenses	**128,961**	111,359	101,597
Collection fees	**36,735**	36,904	35,916
	2,537,596	2,545,745	2,562,062
Less – wages charged to investment in fixed assets (1)	**191,145**	198,297	195,515
	2,346,451	2,347,448	2,366,547

(1) Commencing February 2003, following the establishment of a new reporting system in the Company which allows precise measurement of the direct costs of employees in the Engineering Division and the Information Technology Division, the Company capitalized an additional sum for self-constructed fixed assets. The additional amount for the period ended December 31, 2005 is approximately NIS 42 million (2004 – NIS 50 million).

NOTE 23 – FINANCING EXPENSES, NET

Consolidated

	For the year ended December 31		
	2005	**2004**	**2003**
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	**NIS thousands**	**NIS thousands**
Expenses in respect of long-term liabilities			
Debentures	**(245,184)**	(319,522)	(395,393)
Loans	**(405,735)**	(121,329)	(21,015)
	(650,919)	(440,851)	(416,408)
Income in respect of deposits and investments	**218,200**	195,243	249,677
Expenses in respect of derivatives	**(116,852)**	(12,250)	(806)
Short-term bank credit	**(6,012)**	(2,699)	(33,470)
Other income, net	**138,274**	43,028	43,485
	(417,309)	(217,529)	(157,522)

Company

	For the year ended December 31		
	2005	**2004**	**2003**
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	**NIS thousands**	**NIS thousands**
Expenses in respect of long-term liabilities			
Debentures	**(166,604)**	(315,175)	(395,393)
Loans	**(76,163)**	(20,774)	43,618
	(242,767)	(335,949)	(351,775)
Income in respect of deposits and investments	**199,557**	194,761	248,629
Income (expenses) in respect of derivatives	**(129,469)**	3,834	21,024
Other income, net	**91,782**	44,138	19,750
	(80,897)	(93,216)	(62,372)

Financing income (expenses) for 2005 include exchange rate differences amounting to approximately NIS 85,562 thousand and 53,620 thousand in the Company and Consolidated, respectively.

NOTE 24 – OTHER INCOME (EXPENSES), NET

Consolidated

	For the year ended December 31		
	2005	**2004**	**2003**
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	**NIS thousands**	**NIS thousands**
Provision for claims for salary and pension components (1)	**–**	207,000	(195,000)
Provision for employee severance benefits upon early retirement (2)	**83,000**	(105,000)	(419,016)
Write-off and impairment of fixed assets (3)	**(830)**	–	(327,295)
Provision for impairment and other liabilities in respect of investments in other companies	**(5,868)**	(26,000)	(42,908)
Indemnity for settlement agreement	**14,483**	–	–
Amortization of goodwill	**(93,112)**	(35,135)	(1,032)
Capital gain from sale of operation (4)	**103,869**	35,033	–
Capital gains, net	**5,715**	7,338	1,634
Other	**2,129**	(3,556)	439
	109,386	79,680	(983,178)

Company

	For the year ended December 31		
	2005	**2004**	**2003**
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	**NIS thousands**	**NIS thousands**
Provision for claims for salary and pension components (1)	**–**	207,000	(195,000)
Provision for employee severance benefits upon early retirement (2)	**83,000**	(105,000)	(419,016)
Write-off and impairment of fixed assets (3)	**–**	–	(198,686)
Provision for impairment and other liabilities in respect of investments in other companies	**(5,868)**	(26,000)	(36,110)
Indemnity for settlement agreement	**14,483**	–	–
Capital gain from sale of operation (4)	**103,869**	35,033	–
Capital gains, net	**5,385**	5,674	1,570
Other	**143**	(6,803)	294
	201,012	109,904	(846,948)

(1) See Note 19A(4).
(2) See Note 16D.
(3) See Note 9F, 9G and 9H.
(4) See Note 9C.

NOTE 25 – EARNINGS PER SHARE (CONSOLIDATED AND COMPANY)

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Primary and diluted earnings (loss) before cumulative effect of the change in accounting method	**575,858**	620,825	(437,836)
Primary and diluted net earnings (loss) for the year	**590,858**	620,825	(437,836)
Weighted number of shares in primary earnings and diluted earnings	**2,605,046**	2,605,046	2,444,891

NOTE 26 – BUSINESS SEGMENTS

The Company operates in various segments of the communications sector, with each company in the Group operating in a separate business segment.

Each company provides services in the segment in which it operates by means of the fixed assets and the infrastructure it owns. The infrastructure of each company is used for providing its services only. Each of the companies in the Group is exposed to different risks and yield opportunities, primarily in relation to the technology and competition in the sector in which it operates.

Each company in the Bezeq Group is a separable component, since each company's business is the provision of service or group of related services, and each company is exposed to different risks and yield opportunities from those of other components.
Based on the above, the business segments of the Bezeq Group are as follows:

- “Bezeq”, The Israel Telecommunication Corp. Ltd.– Domestic fixed-line communications.
- Pelephone Communications Ltd. – Cellular telephone.
- Bezeq International Ltd. – International communications and internet services.
- D.B.S. Satellite Services (1998) Ltd. – Multi-channel television.

The other companies of the Group are presented in other sections.

NOTE 26 – BUSINESS SEGMENTS (CONTD.)

A. Business Segments

Consolidated

	For the year ended December 31, 2005						
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues							
Revenues from external sources	4,457,189	4,413,421	795,176	1,200,865	232,035	-	11,098,686
Inter-segment revenues	266,545	14,854	21,488	20,997	104,511	(428,395)	-
Total revenues	4,723,734	4,428,275	816,664	1,221,862	336,546	(428,395)	11,098,686
Segment results	851,273	466,165	97,978	(99,535)	1,197	-	1,317,078
Financing expenses							(417,309)
Earnings after financing expenses							899,769
Other income, net							109,386
Earnings before income tax							1,009,155
Income tax							(429,594)
Earnings after income tax							579,561
Equity in losses of affiliated companies							(12,645)
Minority share in losses of a consolidated company							8,942
Earnings before cumulative effect of the change in accounting method							575,858
Cumulative effect as at the beginning of the year of the change in accounting method							15,000
Net earnings							590,858

NOTE 26 – BUSINESS SEGMENTS (CONTD.)

A. Business Segments (contd.)

Consolidated

	For the year ended December 31, 2005						
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Identified assets	8,217,243	4,834,849	683,068	1,348,813	254,166	(185,581)	15,152,558
Investment by equity method							75,467
General assets							5,437,847
Total consolidated assets							20,665,872
Segment liabilities	1,263,755	718,903	227,859	584,368	128,827	(209,331)	2,714,381
General liabilities							9,893,631
Total consolidated liabilities							12,608,012
Capital investments	787,790	586,447	39,475	247,713	17,452		
Depreciation and amortization	1,390,435	625,393	91,435	298,658	20,729		

NOTE 26 – BUSINESS SEGMENTS (CONTD.)

A. Business Segments (contd.)

Consolidated

	For the year ended December 31, 2004						
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues							
Revenues from external sources	4,736,756	2,966,486	797,735	529,838	238,989	-	9,269,804
Inter-segment revenues	222,935	8,493	18,704	12,304	80,387	(342,823)	-
Total revenues	4,959,691	2,974,979	816,439	542,142	319,376	(342,823)	9,269,804
Segment results	971,016	379,328	118,223	(85,381)	8,362	-	1,391,548
Financing expenses							(217,529)
Earnings after financing expenses							1,174,019
Other income, net							79,680
Earnings before income tax							1,253,699
Income tax							(497,485)
Earnings after income tax							756,214
Equity in losses of affiliated companies				(126,630)	(8,143)		(134,773)
Minority share in earnings of a consolidated company							(616)
Net earnings							620,825
Identified assets	8,589,680	4,775,659	598,090	1,364,941	235,240	(206,476)	15,357,134
Investment by equity method							70,308
General assets							4,744,539
Total consolidated assets							20,171,981

NOTE 26 – BUSINESS SEGMENTS (CONTD.)

A. Business Segments (contd.)

Consolidated

	For the year ended December 31, 2004						
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Segment liabilities	1,412,990	858,943	233,113	595,229	133,360	(200,811)	3,032,824
General liabilities							9,673,390
Total consolidated liabilities							12,706,214
Capital investments	850,005	588,002	116,938	160,134	173,353		
Depreciation and amortization	1,502,354	418,925	117,316	162,029	18,978		

NOTE 26 – BUSINESS SEGMENTS (CONTD.)

A. Business Segments (contd.)

Consolidated

	For the year ended December 31, 2003					
	Domestic fixed–line communications	Cellular telephone	International communications and internet services	Others	Adjustments	Consolidated
	Adjusted for the effects of inflation in shekels of December 2003					
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues						
Revenues from external sources	5,023,754	2,021,807	689,378	246,329	–	7,981,268
Inter-segment revenues	206,807	5,568	13,958	40,236	(266,569)	–
Total revenues	5,230,561	2,027,375	703,336	286,565	(266,569)	7,981,268
Segment results	906,619	96,013	90,001	72	644	1,093,349
Financing expenses						(157,522)
Earnings after financing expenses						935,827
Other expenses, net						(983,178)
Loss before income tax						(47,351)
Income tax						(48,013)
Loss after income tax						(95,364)
Equity in losses of affiliated companies	(2,280)			(341,054)		(343,334)
Minority share in losses of a consolidated company						862
Net loss						(437,836)
Identified assets	9,903,468	2,258,000	527,565	213,574	(106,196)	12,796,411
Investment by equity method						240,667
General assets						3,051,686
Total consolidated assets						16,088,764
Segment liabilities	1,609,316	500,091	270,031	126,516	(102,649)	2,403,305
General liabilities						6,840,517
Total consolidated liabilities						9,243,822
Capital investments	815,382	524,644	114,456	201,670		
Depreciation and amortization	1,776,279	394,203	99,868	7,498		

NOTE 26 – BUSINESS SEGMENTS (CONTD.)

B. Distribution of the Group's Revenues

The table below provides additional information about the distribution of revenue in the Group according to customer use. The costs relating to this revenue cannot be allocated since expenses relating directly to them are impossible to identify, nor can they be allocated on a reasonable basis.

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS millions	NIS millions	NIS millions
Telephony – domestic calls, fixed fees and installations	**3,105**	3,329	3,549
Cellular telephone	**4,532**	3,128	2,199
Multi-channel television services to subscribers	**1,171**	530	-
Internet	**867**	773	643
International communications	**564**	599	562
Transmission services and data communication	**584**	608	648
Fixed line infrastructure and maintenance works	**221**	230	298
Others	**55**	73	82
Total	**11,099**	9,270	7,981

NOTE 27 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES

A. The Company and its subsidiaries provide a range of communication services, such as telephony, access, information and data communication, transmission, satellite and video, various infrastructure services, international communications and internet, multi-channel television, cellular and NET services and so on ("the Services").

The entities to which the Company and its subsidiaries provide the Services include interested parties in the Company, among them Ap.Sb.Ar., which holds 30% of the Company's shares, the State of Israel, which holds approximately 16.38% of the Company's shares, and the Zeevi Holdings Group, which holds approximately 17.75% of the Company's shares through a receiver appointed for those shares on behalf of certain banks.

In view of the above, as far as interested parties who are not the State of Israel are concerned, the Services with which the Company and its subsidiaries provide them are negligible transactions and accordingly, pursuant to Article 64(3)(d)(1) of the Securities Regulations (Preparing annual financial statements), 5753-1993 ("the Regulations"), they are not described in these reports.

As far as the State of Israel is concerned as an interested party in the Company – prior to amendment of the Securities Regulations (Preparing annual financial statements) (Amendment), 5765-2005, since a description of transactions relating to the regular provision of the Services would involve numerous difficulties (it concerns the provision of a range of services to the State and its numerous branches, including government ministries, state corporations, government authorities and companies), the Company was granted an exemption from describing the transactions. Now, in view of the amendment of the Regulations, a general description will be given of typical transactions and their scope, in accordance with Article 64(3)(d)(2) of the Regulations:

NOTE 27 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

A. (CONTD.)

(1) The Services are defined above.

(2) The consideration in respect of most of the transactions made by the Company with State authorities is paid according to the tariffs prescribed in regulations. The remainder of transactions made by the Company with State authorities (for which the consideration is not paid according to the tariffs prescribed in regulations), such as services for which no tariff is prescribed in the regulations, specially ordered work, work as a contractor, excavation works and the installation and maintenance of offices, as well as transactions made by the Company's subsidiaries with State authorities - all these are transactions in the normal course of their business at market prices, where each individual transaction or Service of itself is not material for the Company.

(3) The transactions with government ministries for the group and for the report period are:
Royalties expenses NIS 257,445 thousand, frequencies NIS 30,762 thousand, revenues from telephony services (mainly) NIS 385,171 thousand. Debit/credit balances in respect of these services: trade receivables NIS 91,727 thousand, trade payables NIS 49,936 thousand, current liabilities NIS 183,163 thousand.

Arrangements which to not comply with these conditions are disclosed in the Company's reports.

B. In July 2002 the Company reached an agreement with the Ministry of Defense on behalf of the State of Israel, for the provision of telecommunications services by the Company.

The main points of the agreement, which was approved when the Company was controlled by the State by all of the Company’s authorized bodies, including the General Meeting of the shareholders, as required under the Companies Law for a transaction with a controlling interest, are as follows:

(1) The Company will provide telecommunications services to the IDF at a special discounted rate of approximately 28% for services which the Company provided to the IDF prior to signing the agreement and at 14% for services which did not exist or which the Company did not provide for the IDF prior to signing the agreement. Based on the volume of the services which the Company provided to the IDF prior to the date on which the agreement took effect, the discount in respect of the services under the agreement is not materially different from the discount which was granted pursuant to the memorandum by which the parties acted prior to signing the agreement.

(2) The Ministry of Defense undertakes to purchase Company services for which the consideration will be at least approximately NIS 81.2 million (excluding VAT) for each year of the commitment, and additionally to order from the Company cabling and communications infrastructure development works inside IDF bases which are used to provide the Company's services, for which the consideration will not be less than 80% of the total financial volume of Ministry of Defense orders for such infrastructures for the IDF in each year of the commitment.

(3) The agreement ends and exhausts all the disputes between the parties up to April 1, 2001, including the disputes which were brought before the special professional committee ("the Gabai Committee"), but excludes the matter of an 18% discount which the Ministry of Defense deducted from payments which the Company collected for other communications providers.

(4) Ownership of the infrastructures inside IDF bases at the end of the agreement term will remain with the Ministry of Defense and ownership of infrastructures outside the IDF bases will remain with the Company.

(5) The term of the contract is from the date of signing the agreement – July 21, 2002, until March 31, 2005 (under the terms of the agreement, retroactive accounting was carried out starting from April 1, 2001, subsequent to which the Company received a refund in an immaterial amount).

NOTE 27 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

B. (CONTD.)

On May 8, 2005, a new commercial agreement was signed between the Company and the Ministry of Defense in the name of the State of Israel, for the provision of communication services by the Company. The agreement had been approved earlier by the Audit Committee of the Board of Directors and by the Board of Directors on May 3, 2005, and requires the approval of the general meeting of the shareholders of the Company (by a special majority), in accordance with the Securities regulations (Transaction between a company and its controlling shareholder), 5761-2001. On June 2, 2005 and at the request of the Company, the General Meeting of the Company resolved to remove this subject from its agenda, in view of a query made by the Ministry of Communications and the State's subsequent request to postpone the discussion. The Ministry of Communications query contended, *inter alia*, that the agreement was for giving discounts which seemingly contravenes the provisions of the law and the general license of the Company. The Ministry requested the Company's comments for clarification of the matter. The Company submitted its comments to the Ministry, stating that it was a new framework agreement to replace the previous one, under which the Company had also given the IDF discounts of various percentages. The Company pointed out that its license allows it to enter into a special agreement with the Ministry of Defense for providing the IDF with telecommunication services, which would include any conditions agreed upon by the parties, including discounts, as was the case in the previous framework agreement. The Ministry of Communications has not yet completed its investigation of this matter.

In addition, the Company received a query from the Antitrust Commissioner which noted that the above agreement appeared to contravene the provisions of the Antitrust Law. The Company submitted its comments to the Commissioner. As at the date of approval of the financial statements, the Company intends, together with the Ministry of Defense, to look into alternatives to the agreement. The financial statements include a liability of NIS 19 million, which constitutes the difference in tariffs under the agreement from July 2002 and the agreement from May 8, 2005.

On December 16, 2003, the Company filed a claim in the Tel Aviv District Court against the Ministry of Defense for payment of approximately NIS 57 million in connection with a dispute in the matter of a discount of 18% deducted by the Ministry, as referred to in item (3) above, and on March 16, 2004 the State filed a statement of defense. On May 17, 2004 the Company filed its response. As proposed by the Court, the parties agreed to refer the case to a mediation proceeding, but eventually decided to try to resolve their differences out of court. In April 2005 a settlement agreement was signed, which was approved by the Audit Committee of the Board of Directors and by the Board of Directors. On June 2, 2005, the General Meeting of the shareholders of the Company approved the agreement, as required by the Securities Regulations (Transaction between a company and its controlling shareholder), 5761-2001. In June 2005 the settlement agreement was approved by the Court and validated as a judgment.

Below are the main points of the settlement agreement:

(1) In clearance of a financial claim in the amount of approximately NIS 37.4 million (principal) plus interest in an estimated amount of NIS 20 million, filed by the Company against the State in the matter of the deduction of discounts of 18% on various charges included under the "Miscellaneous" item in the telephone bills of the IDF, the Ministry of Defense will pay the Company a global sum of NIS 28.5 million (including VAT insofar as applicable), in three equal payments of NIS 9.5 million each, which will be paid by the following dates: June 30, 2005, January 31, 2006, June 30, 2006.

(2) Arrears in any one of the payments will entail payment of Accountant General's arrearage interest by the Ministry of Defense.

(3) Subject to the above, neither party shall have any allegation and/or demand and/or claim against the other in this matter.

Following the settlement agreement, the Company cancelled a provision of approximately NIS 15 million.

NOTE 27 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

C. On March 1, 2006, the Audit Committee of the Board of Directors and the Board of Directors approved the Company's commitment in a management agreement with a company owned and controlled by the shareholders of Ap.Sb.Ar. ("the Management Company"), whereby the Management Company will provide the Company with management and consultation services for managing the business of the Bezeq Group. The consideration in respect of these services, according to the agreement, will be approximately $1.2 million plus VAT. The term of the agreement is from October 11, 2005 to December 31, 2008, unless one of the parties gives the other three months notice of its wish to terminate it. The agreement requires the approval of the General Meeting (see also Section E below).

D. **TRANSACTIONS WITH INVESTEE COMPANIES (COMPANY)**

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Consolidated companies			
Revenues –			
Interconnect and access fees	**160,050**	48,320	38,515
Services, royalties and commissions	**95,131**	92,688	52,940
Rent and usage fees for buildings and equipment	**11,364**	4,034	541
Interest	**117,186**	70,458	12,298
Expenses –			
Purchase of services	**61,261**	46,221	47,092
Proportionally consolidated company			
Revenues –			
Interconnect and access fees	**–**	37,533	58,458
Services, royalties and commissions	**–**	103,790	41,425
Rent and usage fees for buildings and equipment	**–**	10,341	6,818
Interest	**–**	1,240	–
Expenses –			
Purchase of services	**–**	3,901	2,481
Interest	**–**	–	551
Affiliated companies			
Revenues –			
Services, royalties and commissions	**–**	8,063	2,812

For balances with investee companies, see the relevant notes.

For loans to investee companies and the terms of those loans, see Note 8 and Note 14A(1).

NOTE 27 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

E. BENEFITS FOR DIRECTORS AND THE CEO

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effect of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Total cost of compensation of the CEO and the Chairman of the Board *	7,893	1,574	1,678
Number of employees	3	2	3
Compensation of members of the Board of Directors who are not Company employees**	1,643	1,663	1,695
Number of directors receiving compensation***	8	13	16
Management fees to a company that is a controlling shareholder****	1,250	–	–

* The cost in respect of 2005 includes salary and grants in respect of the period when the CEO of the Company was CEO of Pelephone, as well as salary and grants for the outgoing CEO and salary and retirement pay to the Chairman of the Board. The salary includes options which were distributed according to the stock options plan – see Note 1G. The cost for 2003 includes retirement pay to the outgoing CEO.

** Compensation for directors in a proportionally consolidated company is stated at the proportional share of the Company (50%) for the period in which that company was proportionally consolidated.

*** From the date of transfer of control of the Company to Ap.Sb.Ar., the directors serving on the Board of Directors of the Company (except for the external directors) do not receive compensation from the Company.

**** A provision of NIS 1,250 thousand for payment of management fees to Ap.Sb.Ar – see Section C above.

(1) On December 3, 2003, the General Meeting of the shareholders of the Company approved a commitment to indemnify officers of the Company in the matter of the framework agreement signed between the Company and the State, including in connection with an allotment of shares to the State by virtue of that agreement. The commitment was limited to NIS 890,000 thousand (the amount of the capital raising), linked to the CPI published after the capital was raised in accordance with the framework agreement.

(2) On May 13, 2004, the General Meeting of shareholders of the Company approved an undertaking to officers on the subject of indemnification and insurance, as follows:

a. An undertaking by the Company regarding the extension of a loan to officers to finance reasonable litigation expenses in legal proceedings, and an undertaking by the Company to acquire an insurance policy for officers at a reasonable cost.

b. Grant of notes of indemnity in advance to officers of the Company on the following matters:

1. The claim of a shareholder holding 15% or more of the share capital of the Company. The total extent of the indemnity will not exceed $150 million plus $30 million for legal expenses (a claim of this kind was excluded in the officers insurance policy of the Company).

NOTE 27 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

E. BENEFITS FOR DIRECTORS AND THE CEO (CONTD.)

2. In everything related to a prospectus for an offer for sale of securities of the Company by the State of Israel and an issuance by the Company, which was published at the end of May 2004. The total amount of the indemnity (including in respect of commitments to indemnify in advance which were given until publication of the prospectus and in respect of commitments to indemnify in advance which will be given, if given, prior to the transfer of control in the Company by the State) shall not exceed 25% of the shareholders' equity of the Company (according to its 2003 financial statements), linked to the CPI of November 2003).

(3) On April 20, 2004, the Board of Directors of the Company resolved that the Company would indemnify the employees of the Group who took part in preparation of the prospectus to be published in May 2004, who are not officers of the Company, in respect of financial liability that would be imposed upon them and in respect of reasonable litigation expenses that they might face, with respect to the prospectus, similar in form to the indemnity given to officers.

(4) The Company has an officers' insurance policy. The insurance ceiling is $150 million per occurrence and for the period (12 months), plus up to $30 million for legal expenses in Israel.

During 2005 the Company purchased officers' liability insurance policies, and commitments were made to indemnify directors and officers as follows:

a. On April 6, 2005, the General Meeting of the shareholders approved an undertaking by the Company to indemnify in respect of a financial liability that will be imposed upon Company officers and in respect of reasonable litigation expenses they will incur, in everything connected, directly or indirectly, with the process of sale of the State's holdings in the Company.
The undertaking to indemnify will be made to officers who were serving and/or were appointed and/or will be appointed in the Company commencing from the start of the Company's preparations for the sale process until the date of completion the sale proceeding.

The total amount of the indemnity will not exceed 25% of the shareholders' equity of the Company (according to its 2004 financial statements, linked to the CPI of November 2004), including in respect of undertaking to indemnify given in advance up to the date of issue of the deed of indemnity together with an undertaking to indemnify in accordance with the letter of the Minister of Finance dated April 21, 2004, which will be made, if made, prior to the transfer of the controlling interest in the Company by the State.

b. On May 16, 2005, the General Meeting of the shareholders approved the insurance and indemnification of the Company's officers as follows:

(1) Approval of exercise of an option to purchase a run-off policy for the liability of officers in the Company, on the terms of the current policy, with the following changes:

a. For a period of seven years from the date of closing transfer of the State's shares in the Company, which are being sold in accordance with decision of the Ministerial Committee on Privatization dated July 19, 2004 ("the Date of Closing the Sale").

b. The total amount of the insurance cover shall not exceed $150 million, plus $30 million in respect of legal expenses in Israel only.

NOTE 27 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

E. BENEFITS FOR DIRECTORS AND THE CEO (CONTD.)

c. Limits of liability:

(1) Cover for the first three years at a limit of liability of $150 million, plus $30 million in respect of legal expenses in Israel only.
(2) Cover for an additional three years at a limit of liability of $75 million, plus $15 million in respect of legal expenses in Israel only.
(3) Cover for the seventh year at a limit of liability of $25 million, plus $5 million in respect of legal expenses in Israel only.

It is clarified that there is one limit of liability for the entire run-off period.

d. The premium for the entire period of insurance is $3 million (in a single advance payment).

(2) Approval for making a commitment in advance to indemnify an officer in the Company who were serving in the Company at the time of making the commitment to indemnify which applies on the Date of Closing the Sale or who served during the seven years prior to that date, for a financial liability imposed upon him in each of the events listed in the document of indemnity and in the terms set out there, in which the officer acted in good faith and had reasonable grounds to assume that the action is in the best interests of the Company. The undertaking to indemnify shall not apply for an event for which an insurer has recognized liability under an insurance policy; however, if due to an indemnifiable event the officer was ordered to pay an amount exceeding the amount paid to him by the insurer, the Company will indemnify him in the amount of the difference, and subject to the amount of the indemnity for all the Company's officers not exceeding $150 million plus $30 million in respect of legal expenses in Israel only per claim and for each insurance year in the period of insurance. Upon the closing of the transaction for the sale of the State's shares to Ap.Sb.Ar. (October 11, 2005), this undertaking came into force.

These resolutions were approved and came into force on the Date of Closing the Sale (October 11, 2005).

c. On August 3, 2005 the Special General Meeting of the shareholders approved the extension of the term of an officers' insurance policy, including a run-off option, for a period of up to four months at a cost of $112,500 per month, commencing July 31, 2005 (the date of expiration of the previous policy). With the closing of the sale of the State's shares top Ap.Sb.Ar. (October 11, 2005), the run-off option was exercised as described in Section (2)a. above and that policy expired.

d. On November 24, 2005 the General Meeting of the shareholders approved:

(1) The purchase of a policy for insurance of the liability of Company officers for a period of one year commencing October 11, 2005 with a limit of liability of $150 million per claim and for the entire insurance year. In addition, $30 million per claim and for all the claims for the insurance period in respect of legal expenses in Israeli only. A limit of liability for subsidiaries – $50 million (as part of the aforesaid limit of liability). Annual premium – $675,000 + 1.5% stamp duty (it is noted that the scope of the insurance cover is identical to the insurance of officers which was in place until now at the Company, whereas the annual premium is considerably lower than that paid in the past, due to the existence of the concurrent run-off insurance).

NOTE 27 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES (CONTD.)

E. BENEFITS FOR DIRECTORS AND THE CEO (CONTD.)

(2) A "framework transaction" for the Company's commitment in the normal course of business in future insurance policies (after expiration of the current policy, as referred to in section a. above), to cover the liability of directors and officers, as may be from time to time, including directors and officers who are or are likely to be seen as controlling shareholders in the Company, and all by way of a "framework transaction" as defined in the Companies Regulations (Benefits in transactions with interested parties), 5760-2000, at an annual premium of $675,000 plus a sum in the amount of 20% of that premium in respect of the insurance cover existing today (and described above), as well as $30 million per claim and total claims for the period of insurance in respect of legal expenses in Israel only. The limit of liability for subsidiaries is $50 million (as part of he limit of liability referred to above). If insurance cover is purchased in an amount differing from the amount of insurance cover today, the option to increase the premium is up to a ceiling of 20% more than the premium for the current policy ($675,000). In other words, the maximum premium (after the increase) will not exceed $810,000.

F. Regarding guarantees to related parties, see Note 19C.

NOTE 28 – FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

A. DERIVATIVES

The Group is exposed to credit and currency risks during the normal course of its business, and uses derivatives to minimize its exposure to these risks.

The Group has an excess of monetary liabilities over monetary assets in or linked to foreign currency in the amount of approximately NIS 2,520 million, of which the excess of current liabilities over current assets is approximately NIS 952 million. The excess of current liabilities is covered by forward exchange contracts, as described in section C below. The Group has revenues in foreign currency from international telecommunications.

As at December 31, 2005, the excess of CPI-linked monetary liabilities over CPI-linked monetary assets amounted to approximately NIS 4,383 million, of which the excess of current assets over current liabilities was approximately NIS 272 million. As stated in Note 1E, most of the Company's tariffs are subject to government regulation and are revised annually in accordance with the increase in the CPI, net of an efficiency factor.

The Company has limited commitments in derivatives, which are intended solely for purposes of hedging. Regarding the Company's commitments to execute forward exchange contracts as at December 31, 2005 – see section C below.

B. CREDIT RISK

As at December 31, 2005, most of the cash and cash equivalents, as well as bank deposits, are deposited in large Israeli banks. Short-term investments primarily represent investments in government bonds and in debentures of companies traded on the stock exchange in Israel. Accordingly, Management does not expect significant losses deriving from credit risks.

The Group's revenues derive mainly from providing services to customers in Israel. Management reviews customer debts on a current basis and the financial statements include specific provisions which, in Management's opinion, adequately reflect the loss inherent in doubtful debts. The exposure to credit risk in connection with customers is limited, considering their large number.

NOTE 28 – FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (CONTD,)

C. CURRENCY RISK

The Company and the consolidated companies manage their exposure to currency risk deriving from fluctuations in foreign currency exchange rates in respect of assets, liabilities and cash flows denominated in foreign currency. The Group acts to minimize the currency exposure by forward transactions in foreign currency and by purchasing currency options. Hereunder the details of the derivatives of the Company and consolidated companies as at December 31, 2005:

Consolidated

(1) Forward currency transactions - hedging transactions

	Purchased currency	Currency payable	Last repayment date	Amounts receivable	Amounts payable	Fair value	Book value
				NIS millions		NIS millions	
Forward transactions at predetermined currency exchange rate (excluding premium/discount) **-**	Dollar	Shekel	September 2006	361	362	-	-
	Euro	Shekel	December 2006	1,557	1,646	(69)	(70)
	CPI-linked Shekel	Shekel	December 2010	1,237	1,279	–	2

(2) Forward currency transactions - non-hedging transactions

	Purchased currency	Currency payable	Last repayment date	Fair value	Scope of commitment
				NIS millions	
Forward transactions at predetermined currency exchange rate (excluding premium/discount) **-**	Dollar	Shekel	May 2006	(2)	129

NOTE 28 – FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (CONTD.)

C. CURRENCY RISK (CONTD.)

Company

(1) Forward currency transactions - hedging transactions

	Purchased currency	Currency payable	Last repayment date	Amounts receivable	Amounts payable	Fair value	Book value
				NIS millions		NIS millions	
Forward transactions at predetermined currency exchange rate -	Dollar	Shekel	September 2006	288	290	(2)	2
	Euro	Shekel	December 2006	1,557	1,646	(69)	(70)
	CPI-linked Shekel	Shekel	December 2010	1,237	1,279	-	2

NOTE 28 – FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (CONTD.)

D. INTEREST RISK

The Company takes loans at variable interest rates, and therefore its financial results (financing expenses) are exposed to the risk of changing interest rates. The Company also has loans at fixed interest rates which are exposed to possible changes in their fair value.

E. FAIR VALUE OF FINANCIAL INSTRUMENTS

The book value of cash and cash equivalents, short-term investments, trade receivables, other receivables, other current assets, most of the long-term liabilities, trade payables and accrued expenses, are equal or are close to their fair values. The fair value of loans from banks is also close to their book value since they bear interest at roughly the market rate.

Hereunder the differences between the amount recorded in the books and the estimated fair value:

	December 31, 2005	
	Book value	**Fair value**
	NIS thousands	**NIS thousands**
Debentures:		
Issued to the public	1,721,604	1,763,531
CPI-linked	2,049,073	2,252,803
Euro-linked	1,593,387	1,733,622
Unlinked, issued to others	36,423	36,564
Euro-linked, issued to others	29,736	30,381
CPI-linked loans	1,928,222	1,987,961
Unlinked loans	692,305	693,602
Foreign currency loans	563,867	569,483

The fair value of the liabilities presented above is based on the present value of the cash flows related to those liabilities.

NOTE 29 – LINKAGE TERMS OF MONETARY BALANCES AS AT DECEMBER 31, 2005

Consolidated

	In or linked to foreign currency					
	Dollar-linked	Euro-linked	Other	CPI-linked	Unlinked	Total
	NIS Thousands			NIS Thousands		
Assets						
Cash and cash equivalents	100,345	3,074	3	-	2,055,351	2,158,773
Short-term investments*	277,581	24,350	-	1,376,203	720,391	2,398,525
Trade receivables	31,444	-	-	8,871	2,073,197	2,113,512
Other receivables and debit balances	3,407	-	-	14,855	19,922	38,184
Investee companies	-	-	-	5,514	-	5,514
Investments, long-term deposits and debit balances	68,147	32,679	-	94,286	605,544	800,656
	480,924	60,103	3	1,499,729	5,474,405	7,515,164
Liabilities						
Short-term bank credit	-	-	-	-	75,191	75,191
Current maturities of long-term liabilities						
Trade payables	759,495	-	-	899,595	130,660	1,789,750
Other current liabilities	488,894	14,785	1,058	-	895,977	1,400,714
Long-term loans	15,972	112,053	-	228,008	995,236	1,351,269
Other long-term debentures	34,522	-	-	1,469,350	648,088	2,151,960
Employee severance benefits	-	1,623,122	-	3,279,934	-	4,903,056
Other long-term liabilities						
	-	-	-	-	865,305	865,305
	1,707	-	9,135	5,649	2,004	18,495
	1,300,590	1,749,960	10,193	5,882,536	3,612,461	12,555,740

Company

	In or linked to foreign currency					
	Dollar-linked	Euro-linked	Other	CPI-linked	Unlinked	Total
	NIS Thousands			NIS Thousands		
Assets						
Cash and cash equivalents	7,524	3,074	3	-	1,668,643	1,679,244
Short-term investments*	251,073	24,350	-	1,256,217	514,261	2,045,901
Trade receivables	10,062	-	-	-	886,353	896,415
Other receivables and debit balances	3,189	-	-	276,546	7,215	286,950
Investee companies	-	-	-	2,100,070	-	2,100,070
Investments, long-term deposits and debit balances	64,442	32,679	-	79,344	193,041	369,506
	336,290	60,103	3	3,712,177	3,269,513	7,378,086
Liabilities						
Current maturities of long-term liabilities	529,345	-	-	376,461	36,423	942,229
Trade payables	23,619	14,785	1,058	-	500,997	540,459
Other current liabilities	8,007	112,053	-	128,579	633,470	882,109
Long-term loans	34,522	-	-	-	-	34,522
Other long-term debentures	-	1,623,122	-	4,389,462	-	6,012,584
Employee severance benefits	-	-	-	-	842,761	842,761
	595,493	1,749,960	1,058	4,894,502	2,013,651	9,254,664

* Including mutual fund participation certificates of approximately NIS 162 million and NIS 135 million Consolidated and in the Company, respectively..
For details of forward exchange contracts for covering exposure to foreign currency, see Note 28C.

NOTE 29 – LINKAGE TERMS OF MONETARY BALANCES AS AT DECEMBER 31, 2004

Consolidated

	In or linked to foreign currency					
	Dollar-linked	Euro-linked	Other	CPI-linked	Unlinked	Total
	NIS Thousands			NIS Thousands		
Assets						
Cash and cash equivalents	30,373	1,301	–	–	1,425,433	1,457,107
Short-term investments*	171,029	24,757	–	476,622	*615,401	1,287,809
Trade receivables	33,296	–	–	–	2,081,774	2,115,070
Other receivables and debit balances	519	75,982	–	8,038	8,173	92,712
Investee companies	–	–	–	16,414	(12,330)	4,084
Investments, long-term deposits and debit balances	69,048	35,261	–	256,986	478,397	839,692
	304,265	137,301	–	758,060	4,596,848	5,796,474
Liabilities						
Short-term bank credit	–	–	–	–	88,102	88,102
Current maturities of long-term liabilities	604,548	–	–	868,063	72,786	1,545,397
Trade payables	572,048	52,795	1,182	–	1,049,544	1,675,569
Other current liabilities	66,401	44,829	–	169,147	1,087,216	1,367,593
Long-term loans	743,130	–	–	1,425,268	692,536	2,860,934
Other long-term debentures	–	1,749,709	–	2,038,438	36,392	3,824,539
Employee severance benefits	–	–	–	–	1,272,570	1,272,570
Other long-term liabilities	9,247	–	–	437	11,941	21,625
	1,995,374	1,847,333	1,182	4,501,353	4,311,087	12,656,329

Company

	In or linked to foreign currency					
	Dollar-linked	Euro-linked	Other	CPI-linked	Unlinked	Total
	NIS Thousands			NIS Thousands		
Assets						
Cash and cash equivalents	4,262	1,301	–	–	1,322,168	1,327,731
Short-term investments*	171,029	24,757	–	476,622	*613,512	1,285,920
Trade receivables	11,724	–	–	–	959,042	970,766
Other receivables and debit balances	286	75,982	–	103,215	9,697	189,180
Investee companies	–	–	–	2,560,089	–	2,560,089
Investments, long-term deposits and debit balances	60,312	35,261	–	229,614	203,196	528,383
	247,613	137,301	–	3,369,540	3,107,615	6,862,069
Liabilities						
Current maturities of long-term liabilities	469,572	–	–	141,701	72,786	684,059
Trade payables	1,590	52,795	1,182	–	592,651	648,218
Other current liabilities	48,622	44,829	–	145,829	648,271	887,551
Long-term loans	527,730	–	–	2,004	–	529,734
Other long-term debentures	–	1,749,708	–	4,328,527	36,393	6,114,628
Employee severance benefits	–	–	–	–	1,250,829	1,250,829
Other long-term liabilities	–	–	–	437	–	437
	1,047,514	1,847,332	1,182	4,618,498	2,600,930	10,115,456

* Including mutual fund participation certificates of approximately NIS 113 million consolidated and in the Company.
For details of forward exchange contracts for covering exposure to foreign currency, see Note 28C.

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NOTE 30 – CONDENSED FINANCIAL STATEMENTS OF THE COMPANY IN HISTORICAL NOMINAL VALUES FOR TAX PURPOSES

A. ACCOUNTING PRINCIPLES USED FOR STATING DATA IN HISTORICAL NOMINAL VALUES FOR TAX PURPOSES

1. These financial statements were prepared on the historical cost basis.
2. These financial statements include the data of the Company alone, without presentation of consolidated statements, as required under accepted accounting principles.
3. The Company's investments in investee companies are stated on the basis of their historical cost.

B. BALANCE SHEETS

	December 31 2005	December 31 2004
	NIS thousands	NIS thousands
Assets		
Current assets	**5,065,790**	3,954,529
Materials and spare parts	**88,881**	130,922
Investments, long-term deposits and debit balances	**400,423**	569,800
Investment in investee companies	**5,835,689**	6,379,360
Fixed assets	**4,539,216**	4,899,478
Other assets	**572,250**	631,477
	16,502,249	16,565,566
Liabilities		
Current	**2,952,208**	2,833,945
Long-term	**6,337,572**	7,324,091
	9,289,780	10,158,036
Shareholders' equity	**7,212,469**	6,407,530
	16,502,249	16,565,566

NOTE 30 – CONDENSED FINANCIAL STATEMENTS OF THE COMPANY IN HISTORICAL NOMINAL VALUES FOR TAX PURPOSES (CONTD.)

B. STATEMENTS OF OPERATIONS

	For the year ended December 31		
	2005	**2004**	**2003**
	NIS thousands	**NIS thousands**	**NIS thousands**
Revenues from telecommunications services	**4,723,734**	4,959,691	5,285,062
Costs and expenses			
Operating and general expenses	**2,346,451**	2,347,448	2,397,800
Depreciation	**1,140,953**	1,178,829	1,334,060
Royalties to the Government of Israel	**135,575**	145,318	182,181
	3,622,979	3,671,595	3,914,041
Operating income	**1,100,755**	1,288,096	1,371,021
Financing expenses, net	**(80,897)**	(93,216)	(45,667)
Earnings after financing expenses	**1,019,858**	1,194,880	1,325,354
Other income (expenses), net	**201,802**	112,836	(806,725)
Earnings before income tax	**1,221,660**	1,307,716	518,629
Income tax	**(349,449)**	(573,572)	(195,754)
Net earnings (loss) after income tax	**872,211**	734,144	322,875
Equity in earnings (losses) of investee companies	**(68,507)**	26,023	(285,464)
Net earnings (loss)	**803,704**	760,167	37,411

NOTE 30 – CONDENSED FINANCIAL STATEMENTS OF THE COMPANY IN HISTORICAL NOMINAL VALUES FOR TAX PURPOSES (CONTD.)

C. STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY

	Share capital	Capital reserves	Dividend proposed after the balance sheet date	Retained earnings (loss)	Total
	NIS Thousands				
Balance as at January 1, 2003	2,411,658	3,432,994	190,000	(1,115,568)	4,919,084
Changes in 2003					
Net earnings	–	–	–	37,411	37,411
Dividend paid	–	–	(190,000)	–	(190,000)
Allotment of shares	193,388	687,480	–	–	880,868
Balance as at December 31, 2003	2,605,046	4,120,474	–	(1,078,157)	5,647,363
Changes in 2004					
Net earnings	–	–	–	760,167	760,167
Balance as at December 31, 2004	2,605,046	4,120,474	–	(317,990)	6,407,530
Changes in 2005 –					
Net earnings	**–**	**–**	**–**	**803,704**	**803,704**
State's payment in respect of Company privatization	**–**	**1,235**	**–**	**–**	**1,235**
Dividend proposed for payment	**–**	**–**	**1,200,000**	**(1,200,000)**	**–**
Balance as at December 31, 2005	**2,605,046**	**4,121,709**	**1,200,000**	**(714,286)**	**7,212,469**

NOTE 31 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., D.B.S. SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD.

1. PELEPHONE COMMUNICATIONS LTD.

A. BALANCE SHEET

	December 31 2005	December 31 2004
	Reported amounts	Reported amounts
	NIS thousands	NIS thousands
Current assets	**1,881,982**	1,413,049
Long-term trade receivables	**338,281**	278,778
Investment in investee companies	**3,565**	4,084
Deferred income taxes	**19,799**	106,503
Fixed assets	**3,009,219**	3,093,675
Other assets, net	**337,787**	334,028
	5,590,633	5,230,117
Current liabilities	**1,558,012**	1,794,413
Long-term liabilities	**1,666,193**	1,305,674
Shareholders' equity	**2,366,428**	2,130,030
	5,590,633	5,230,117

NOTE 31 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., D.B.S. SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD. (CONTD.)

1. PELEPHONE COMMUNICATIONS LTD. (CONTD.)

B. STATEMENTS OF OPERATIONS

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Revenues from Pelephone services, sales and services	**4,428,277**	4,412,344	4,054,749
Cost of Pelephone services, sales and services	**3,415,885**	3,258,877*	3,239,830*
Gross profit	**1,012,392**	1,153,467	814,919
Sales and marketing expenses	**432,808**	470,409*	471,828*
General and administrative expenses	**107,218**	123,934*	133,201*
	540,026	594,343	605,029
Operating profit	**472,366**	559,124	209,890
Financing expenses, net	**(115,264)**	(99,597)	(143,786)
Other income (expenses), net	**1,136**	3,645	(167)
Earnings (loss) before income tax	**358,238**	463,172	65,937
Income tax	**(113,333)**	(153,400)	(24,273)
Earnings (loss) after income tax	**244,905**	309,772	41,664
Company's equity in losses of investee companies	**(8,507)**	(9,080)	(6,224)
Net earnings (loss)	**236,398**	300,692	35,440

* Reclassified

NOTE 31 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., D.B.S. SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD. (CONTD.)

2. D.B.S. SATELLITE SERVICES (1998) LTD.

A. BALANCE SHEET

	December 31 2005	December 31 2004
	Reported amounts	Reported amounts
	NIS thousands	NIS thousands
Current assets	**154,567**	124,393
Broadcasting rights, net	**154,500**	140,496
Fixed assets, net	**1,047,994**	1,102,066
	1,357,061	1,366,955
Current liabilities	**613,379**	595,229
Long-term liabilities	**1,419,257**	1,299,138
Loans from shareholders	**2,893,024**	2,661,540
Capital deficit	**(3,568,599)**	(3,188,952)
	1,357,061	1,366,955

NOTE 31 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., D.B.S. SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD. (CONTD.)

2. DBS SATELLITE SERVICES (1998) LTD. (CONTD.)

B. STATEMENTS OF OPERATIONS

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Revenues from DBS services	**1,221,863**	1,027,992	842,374
DBS operating expenses	**1,089,835**	1,013,403	1,012,159
Gross profit (loss)	**132,028**	14,589	(169,785)
Sales and marketing expenses	**140,665**	133,511	109,859
General and administrative expenses	**77,055**	72,240	84,691
	217,720	205,751	194,550
Operating loss	**(85,692)**	(191,162)	(364,335)
Financing expenses, net	**(241,335)**	(171,522)	(179,608)
Other expenses, net	**(830)**	(3,200)	(11,201)
Net loss	**(327,857)**	(365,884)	(555,144)

NOTE 31 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., D.B.S. SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD. (CONTD.)

3. BEZEQ INTERNATIONAL LTD.

A. BALANCE SHEET

	December 31 2005	December 31 2004
	Reported amounts	Reported amounts
	NIS thousands	NIS thousands
Current assets	**366,078**	223,302*
Long-term investments and debit balances	**28,702**	26,684*
Fixed assets	**305,826**	355,439
Other assets	**23,625**	18,106
	724,231	623,531
Current liabilities	**401,126**	239,133
Long-term liabilities	**14,835**	181,982
Shareholders' equity	**308,270**	202,416
	724,231	623,531

* Reclassified

NOTE 31 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., D.B.S. SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD. (CONTD.)

3. BEZEQ INTERNATIONAL LTD. (CONTD.)

B. STATEMENTS OF OPERATIONS

	For the year ended December 31		
	2005	2004	2003
	Reported amounts		Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands	NIS thousands	NIS thousands
Revenues from international telecommunication services	**816,664**	816,439	703,336
Operating expenses	**530,806**	506,779*	434,658*
Gross profit	**285,858**	309,660	268,678
Marketing, general and administrative expenses	**193,297**	191,437*	184,707*
Operating income	**92,561**	118,223	83,971
Financing income (expenses), net	**(3,361)**	(4,301)	(21,830)
Earnings after financing	**89,200**	113,922	62,141
Other income (expenses), net	**1,377**	4,656	(128,580)
Earnings (loss) before income tax	**90,577**	118,578	(66,439)
Tax benefit (income tax)	**15,226**	822	(3,489)
Earnings (loss) after income tax	**105,803**	119,400	(69,928)
Company's equity in earnings (losses) of an affiliate	**4,583**	1,440	(619)
Net earnings (loss)	**110,386**	120,840	(70,547)

* Reclassified

Appendix A – List of Group Companies

	Percentage control and ownership as at	
	December 31 2005	**December 31 2004**
	%	**%**
Consolidated Companies		
Bezeq International Ltd.	**100**	100
DBS Satellite Services (1998) Ltd. (1)	**49.8**	49.8
Pelephone Communications Ltd. (2)	**100**	100
GoNext Ltd. (3)	**100**	100
Bezeq Zahav (Holdings) Ltd.(4)	**100**	100
BezeqCall Communications Ltd. (formerly Bezeq Bit 1995 Ltd.) (5)	**100**	100
BezeqCall Ltd. (5)	**100**	100
Bezeq On Line Ltd. (6)	**100**	100
GoldNet Communication Services – registered partnership (7)	**74.9**	74.9
B-One General Partnership (8)	**100**	100
Proportionally Consolidated Company		
Aspire Partnership (18)	**49**	–
Affiliated Companies		
Stage One Venture Capital Fund (Israel) L.P. (an Israeli Limited Partnership) (hereinafter – the Fund) (9)	**100**	100
Stage One Capital Investments L.P. (an Israeli Limited Partnership) (hereinafter – SOCI) (9)	**27**	27
The International Company for Undersea Cables Ltd. (ISCC) (10)	**-**	50
Aphrodite B.V. Amsterdam (11)	**-**	67
Infogate Online Ltd. (12)	**2.47**	8.12
Walla! Communications Ltd.(13)	**42.85**	44.97
Adanet for Business Group Ltd.(14)	**50**	50
Companies that are not investees		
Ambez Ltd. (formerly Comfinet Ltd.)	**17**	17
Xpert Integrated Systems Ltd. (15)	**-**	16
Personeta Inc.	**0.3**	0.6
Exent Ltd.	**3.14**	3.5
Atrica Inc.	**0.31**	0.34
Num4net (16)	**3.82**	4.45
Nexus Telocation Systems Ltd (17)	**4.03**	6
Venture Capital Funds that are not affiliated		
Eurofund 2000 L.P	**15.15**	14.4

(1) See Note 8E.

(2) See Note 8D.

(3) On March 16, 2000, Pelephone signed an agreement for the establishment of GoNext Ltd. (hereinafter – GoNext). The principal operations of GoNext are the set-up and operation of the portal with a link to cellular mediation. On December 29, 2004, Pelephone and GoNext agreed that Pelephone would waive and pardon the balance of its right in GoNext, in the amount of NIS 64,970 thousand, less a current debt balance between the two companies. As a result of this waiver, a capital gain was generated at GoNext, enabling GoNext, for the first time, to allocate the surplus cost created at the time of purchase of half of the shares in GoNext in 2002, to a deferred tax asset. At the beginning of 2005, operations of GoNext were terminated.

(4) Bezeq Zahav (Holdings) Ltd. ("Bezeq Zahav") is wholly owned and controlled by the Company. Bezeq Zahav was established in September 1995 and commenced operations in May 2004. Bezeq Zahav holds debentures which were issued by the Company (see Note 14A(1)).

(5) Commencing July 1, 1997, the operations of the two companies were consolidated and BezeqCall Ltd. ceased its operations.

(6) The company was founded in December 2000 and commenced operations in 2001. The company provides Call Center Outsourcing services.

Appendix A – List of Group Companies (Contd.)

(7) In 2002, following exercise of the Put option with AT&T, the Company's holding in the partnership increased to 54%. In March 2003, Malam Systems Ltd. ("Malam") notified the Company of exercise of a Put option it had towards the Company, to sell 20.9% of its holdings in the partnership. In May 2003, on receipt of the required approvals for changing the holdings in the partnership and on payment of consideration of approximately NIS 6.4 million by the Company, the Company's holdings in the partnership increased to 74.9%, while the holdings of Malam in the partnership decreased to 25.1%, accordingly.

(8) In May 2003, Pelephone, Bezeq International and BezeqCall Communications established the general partnership B-ONE ("the Partnership"), the purpose of which is to market total communications services to the customers of those companies. The Partnership will help increase the sales of the products and services of the parties to the agreement and be a main interface point with customers who purchase products and services through it but which will be supplied directly by each of the partners. In October 2005 Pelephone decided, together with the other partners, to terminate the joint operation. It was decided that the Partnership would continue to provide the billing services and that its customers would be transferred gradually to receipt of service from each of the parties. Upon termination if the operation, it was decided that the companies involved would waive the entire amount and/or a right that had accumulated or would accumulate by the actual date of termination of the operation. With the waiver of the other partners of their part iin the Partnership, Pelephone's part increased in the results of the Partnership to 100%.

(9) The Fund is a venture capital fund, all of whose management rights are held by SOCI, and the Company has rights in profits only. SOCI's management is implemented by an investments committee in which the Company has no control. As the Company does not control SOCI (nor its management of the Fund), the investments are accounted for by the equity method. The Company undertook to invest the sum of $20 million in the Fund, of which approximately $17 million was invested by the end of 2005.

(10) ISCC – The Company maintained an undersea cable that it had laid. The Company's equity in the costs of the equipment and its maintenance is charged to fixed assets and to maintenance expenses. In February 1997, use of the undersea cable was halted. In January 1999, the Board of Directors resolved on the voluntary liquidation commencing March 31, 1999. The liquidation of the company was completed during 2005.

(11) With the sale of Aphrodite's investment in Emitel and transfer of the profit as a dividend to the Company, Aphrodite ceased its operations and was sold. The shares were transferred in February 2005.

(12) Infogate develops and provides ASP concept computer communication services in which computers in a broadband network are connected to a central server and receive various services from that server. In January and November 2005, additional dilutions decreased the Company's holding in Infogate to 2.47%.

(13) See Note 8F.

(14) See Note 8G.

(15) In 2001, the Company invested approximately NIS 40 million in Xpert Integrated Systems Ltd. ("Xpert"), in consideration for 16.26% of the capital of that company, as well as options which would enable it to increase its holdings to 19.53%. Xpert is involved in the construction and provision of integration services in the communications field (primarily in the field of IP) and data security. On July 11, 2005 the Company sold all its holdings (16.3%) in Xpert. The Company's share of the proceeds from the sale amounts to approximately $2.8 million. The payments will be made in installments, the last of which should be received in January 2007.

(16) Num4net develops technology for providing interconnect services for information.

(17) Commencing July 2004, Pelephone holds shares and options of Nexus Telocation Systems Ltd. ("Nexus"), which is traded on Nasdaq in the U.S.A. Pelephone holds these shares and options as a permanent long-term investment , and has no material influence in Nexus.

(18) Aspire Partnership – in the reporting period, BezeqCall Communications set up a general partnership, together with TeleAll Connect Center Ltd. ("TeleAll") in the fields of Voice and Data.
TeleAll is a company which operates in the field of integration of contact center systems. The operations of the new partnership are based on the activity of the department which operated at TeleAll under the name of Aspire Advanced Solutions ("Aspire"), which acquired extensive experience in CTI integration, the development of dedicated software for the contact centers and IP-T related activities. In particular, Aspire acquired extensive and unique experience in the field of integration of the contact center products of Nortel, one of the core suppliers of BezeqCall Communications. The commitment received the approval of BezeqCall Communications' general meeting and the approval of the General Director of the Antitrust Authority.

Chapter D – Additional Details About the Corporation

Chapter 4 – Additional Details About the Corporation

1. Summary of the Quarterly Statements of Operations for the Year Ended December 31, 2005 (In NIS millions)

		2005			
	Total	**Quarter 4**	**Quarter 3**	**Quarter 2**	**Quarter 1**
Revenues	11,099	2,760	2,839	2,727	2,773
Costs and expenses	9,782	2,496	2,489	2,390	2,407
Operating profit	1,317	264	350	337	366
Financing Expenses	(417)	(145)	(107)	(110)	(55)
Other Income (Expenses)	109	(21)	(22)	65	88
Equity in losses of investee companies	(3.7)	0.4	(2)	(1)	(1.3)
Net earnings	591	44	103	164	280

2. Use of Proceeds from Securities with Reference to the Application of the Proceeds According to a Prospectus

An offer for sale and issuance according to a prospectus was published on May 24, 2004. The designation of the proceeds from the offering – "as will be decided by the Company from time to time according to its needs, including, taking into account the necessity of replacing loans by early repayment. As at the date of approval of the financial statements, there has been no need to replace such loans (except for a loan of NIS 5 million which was repaid by the Company before its due date).

3. List of Investments in Subsidiaries and Affiliated Companies as at the Balance Sheet Date

Company name	Name of holder	Class of Share	Number of shares	Total par value	Rate of holding in %	Adjusted cost in NIS thousands	Adjusted balance sheet value in NIS thousands
Pelephone Communications Ltd.	The Company	Ordinary NIS 1	302,460,000	302,460,000	100%	2,524,491	3,339,060
Bezeq International Ltd.[1]	The Company	Ordinary NIS 0.1	1,000,000,000	100,000,000	100%	479,620	489,889
BezeqCall Communication Ltd.	The Company	Ordinary NIS 1	35,537,220	35,537,220	100%	51,768	59,279
DBS Satellite services (1998) Ltd.[2]	The Company	Ordinary NIS 1	14,770	14,770	49.77%	1,778,488	43,630
Bezeq Online Ltd.[3]	The Company	Ordinary NIS 1	85,000	85,000	100%	24,418	15,502
Bezeq Zahav (Holdings) Ltd.[4]	The Company	Ordinary NIS 1	999,999	999,999	100%	2,100,070	2,100,070
Walla! Communications Ltd.[5]	Bezeq International	Ordinary NIS 1	12,489,116	12,489,116	42.85%[6]	80,558	19,746
BezeqCall Ltd.[7]	The Company	Ordinary NIS 0.1	400,000,000	40,000,000	100%	0	3,904

* Note: Adanet Business Group Ltd. – Adanet and its subsidiaries are in liquidation/receivership proceedings.

1 Bezeq International includes an investment of NIS 173,258 thousands which was extended as a CPI-linked shareholders' loan. This loan was defrayed in full on February 14, 2006.

2 D.B.S. Satellite Services (1998) Ltd. includes an investment of NIS 1,778,488 thousand by means of loans. Of which, NIS 1,006,232 thousand is in loans linked to the known CPI, NIS 192,236 thousand in loans linked to the known CPI and bearing 5.5% interest, and NIS 580,020 thousand is in loans linked to the known CPI and bearing 11% interest.

3 Bezeq Online Ltd. includes an investment of NIS 1,048 thousand, extended as a shareholder loan. The loan is linked to the CPI and is interest-free.

4 A loan was extended to the subsidiary Bezeq Zahav (Holdings) Ltd. for financing the purchase of debentures Series 4 and 5 as allotted to it.

5 Walla! Communications Ltd. includes an investment of NIS 5,514 thousand which was made by means of shareholders' loans from Bezeq International. The loans are linked to the CPI and are interest-free. During 2005, Bezeq International exercised another 213,397 options in consideration of NIS 384,115 thousand, which was set off from the balance of those loans.

6 At full dilution – 33.94%.

7 Inactive company.

4. Changes in Investments in Subsidiaries and Related Companies During the Report Period

Date of the change	Character of the change	Company name	Reported amounts NIS thousands
1/05	Shareholder's Loan	DBS	30,000
2/05	Shareholder's Loan	DBS	6,000
3/05	Shareholder's Loan	DBS	1,400
7/05	Shareholder's Loan	DBS	6,500
8/05	Shareholder's Loan	DBS	21,000
12/05	Linkage differentials	DBS	110,036
1/05	Repayment of loan.	Bezeq Zahav (Holdings) Ltd.	-100,000
2/05	Repayment of loan.	Bezeq Zahav (Holdings) Ltd.	-200,000
6/05	Repayment of loan.	Bezeq Zahav (Holdings) Ltd.	-100,000
8/05	Repayment of loan.	Bezeq Zahav (Holdings) Ltd.	-100,000
3/05	Exercise of option warrants	Walla! Communications Ltd.	There is no transition change between shareholder loans and an investment
2005	Premium reduction	Bezeq Zahav (Holdings) Ltd.	-12,415
2005	Revaluation	Bezeq Zahav (Holdings) Ltd.	52,396
Q4 2005	Exercise of options	Walla! Communications Ltd.	600

5. Revenues of Subsidiaries and Related Companies and Revenues of the Corporation from them as at the Balance Sheet Date (In NIS thousands)

Company name	Earnings (loss) before tax	Earnings (loss) after tax	Dividend	Management Fees	Interest
	NIS thousands				
Pelephone Communications Ltd.	358,238	236,398	0	0	0
Bezeq International Ltd.	90,577	110,386	0	0	0
BezeqCall Communication Ltd.	3,752	4,627	0	0	0
BezeqCall Ltd.	0	0	0	0	0
D.B.S. Satellite Services (1998) Ltd.	(327,857)	(327,857)	0	0	83,710
Bezeq Online Ltd.	(8,505)	(8,764)	0	0	930
Bezeq Zahav Holdings Ltd.	0	0	0	0	92,546
Walla! Communications Ltd.	12,169	12,332	0	0	0

6. Stock Exchange Trading – Listed Securities – Dates and Reasons for Termination of Trading

Date	Security No.	Security name	Quantity	New balance
04.04.05	2300069	Debentures Series 5	286,967,000	2,386,967,000

As at the date publication of the periodic report, the subsidiary Bezeq Zahav (Holdings) Ltd. holds 1,950,000 debentures Series 5.

7. Payment to Senior Officers

Cost of salary	2005
	Reported amounts in NIS thousands
CEO*	5,923
Deputy CEO*	1,750
Former CEO	1,515
Director	1,323
Former deputy CEO	1,117

*The total cost includes salaries and benefits relating to their tenure of employment at Pelephone.

8. Salary and Benefits

A. In 2005, members of the Board of Directors who served in the Company until October 11, 2005 (the date of transfer of control) (except for the former chairman and directors on behalf of the employees in the employ of the Company) received remuneration, salary and incidental expenses amounting to NIS 1,643 thousand.

Commencing October 11, 2005, no remuneration is paid to the directors, except for external directors.

B. The cost of salary of the Chairperson of the Board until March 6, 2005 (the date of her retirement) was NIS 455 thousand.

C. Regarding a management fee agreement, see Note 27 to the financial statements

Subject to the approval of the General Meeting of the Company, the management fee for the period from October 11, 2005 until December 31, 2005 – NIS 1,250 thousand.

9. Shares and Convertible Securities Held by Interested Parties in the Corporation, a Subsidiary or an Affiliated Company, as Close as Possible to the Report Date

	Name of holder	Type of security	Number of convertible securities	Number of shares	Value in NIS par value	Percentage of holding in control and in equity
1.	State of Israel[8]	Ordinary		426,797,766	426,797,766.00	16.38
2.	Zeevi Communications Holdings Ltd.[9]	Ordinary		459,331,617	459,331,617.00	17.63
3.	D.E. Dirot Elite Ltd.	Ordinary		3,097,697	3,097,697.00	0.12
4.	Ap.Sb.Ar. Holdings Ltd. through Romema Investments Co. Ltd.	Ordinary		781,513,683	781,513,683	30.00
5.	Alan (Chanoch) Barkat (director)	Ordinary		10,500	10,500	
6.	Ran Gotfried (director)	Ordinary		12,000	12,000	

10. Registered Capital, Issued Capital and Convertible Securities

The registered capital 2,625,000,000 shares of NIS 1 par value each
Issued capital 2,605,045,611 shares of NIS 1 par value each, having equal rights.
There are no dormant shares, there are no convertible securities.

11. Registered Address of the Corporation

Address 15 Hatzvi Street, Jerusalem 91010
Telephone 1: 03-6262200; Telephone 2: 03-6262300; Fax: 03-6262209
email: Bosmatch@Bezeq.com (Corporate secretary)

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[8] In accordance with the agreement between Ap.Sb.Ar Holdings Ltd. and the State for the purchase of the State's holdings in the Company, Ap.Sb.Ar Holdings Ltd. has an option to purchase up to 277,697,862 shares in the Company (which constitute approximately 10.66% of the Company's share capital), which can be exercised until the first business day occurring 48 months after October 11, 2005 (the date of closing the purchase of the Company's shares). Under the aforesaid agreement, Ap.Sb.Ar. Holdings Ltd. will be entitled to request that the State vote with it (within the limits defined in the agreement concerning certain matters) for 10.66% of the Company's shares held by the State and for which Ap.Sb.Ar. Holdings Ltd. received an option to purchase, and for 1.01% of the Company's shares which will remain in the State's hands in the period commencing on October 11, 2005 (the date of closing the transaction) and ending at the end of the option exercise period as aforesaid, and for 4.71% of the Company's shares held by the State, which are designated for allotment to Company employees – for a period as aforesaid or until the transfer of ownership of those shares to Company employees, the earlier of the two.

[9] On November 12, 2002, a receiver was appointed to this company, Adv. Alex Hartman, who is authorized to exercise the rights in respect of the Company's shares in accordance with the ruling and approval of the court. It should be noted that this company belongs to the Zeevi Group, and that another company of the same group, D.E. Dirot Elite Ltd., (as specified in Section 3) also holds shares in the Company.

[10] See Note 8 above.

12. Directors of the Corporation

A. (1) Name: **Moshe (Mori) Arkin*** ID. No. 051643062
(2) Date of birth: October 23, 1952
(3) Address: 22 Derech Haganim, Kfar Shmaryahu
(4) Citizenship: Israeli
(5) Membership of Board of Directors Committees: Chairman of the Security Committee, Chairman of the Executive Committee
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party: No
The director is Chairman of the Company's Board of Directors (as of October 11, 2005)
(8) Date of start of tenure as a director: October 11, 2005
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
BA – Psychology, Tel Aviv University
BA – Philosophy, Tel Aviv University
Since October 11, 2005 – Chairman of the Board of Bezeq
1983-2005 – Chairman of the Board of Agis Industries (1983) Ltd.
From 2005 – Deputy Chairman of the Board of Frigo.
From 2001 – President of Agis Industries (1983) Ltd.
Until 2001 – CEO of Agis Industries (1983) Ltd.
Director at:
Ap.Sb.Ar. Holdings Ltd.
Arkin Communications Ltd.
Frigo
M. Arkin (1999) Ltd.
Arkin Real Estate Holdings (1981) Ltd.
Arkin-Yanai Holdings Ltd.
Arkin Assets Ltd.
Moshe and Daniela Arkin Promotions and Investments Ltd.
(10) Related to an interested party in the Corporation: No

* Arkin Communications Ltd., which is wholly owned by Moshe Arkin, owns 10% of the capital and 19% of the voting rights of Ap.Sb.Ar. Holdings Ltd. Ap.Sb.Ar. Holdings Ltd. owns 30% of the Company's share capital(which is held in trust by Romema Investments Co. Ltd.)

B. (1) Name: **Pinchas (Barel) Buchris** ID No. 053305868
(2) Date of birth: April 11, 1956
(3) Address: Apax, 2 Maskit Street, Herzliya 46120
(4) Citizenship: Israeli
(5) Membership of Board of Directors Committees: Security Committee
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party: The director is an independent partner in the Apax Israel Investment Fund.
(8) Date of start of tenure as a director: October 11, 2005
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
BSc – The Technion, Israel Institute of Technology
MBA – Derby University
From 2003 – Independent partner in the Apax Israel Investment Fund
Director at:
Escape Rescue Systems Ltd.
Go Networks
Gmn
Raysat
A. Nuriel Knafaim Holdings
(10) Related to an interested party in the Corporation: No

C. (1) Name: **Alan (Chanoch) Barkat** ID. No. 012664769
(2) Date of birth: September 3, 1952
(3) Address: Hashachar 32, Raanana
(4) Citizenship: Israeli + Canadian
(5) Membership of Board of Directors Committees: No
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party: No
(8) Date of start of tenure as a director: October 11, 2005
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
MBA – Kellog-Recanati Senior Management Program
BSc Computer Engineering – The Technion, Israel Institute of Technology
1995 - 2005 Head of the Israeli branch of the Apax Investment Fund
Director at:
Fiberxon (observer only)
Hapoel Tel Aviv Football club
Ap.Sb.Ar. Holdings Ltd
(10) Related to an interested party in the Corporation: No

D. (1) Name**: Ran Gottfried** ID No. 006357206
(2) Date of birth: August 20, 1944
(3) Address: 64 Pinkas Street, Tel Aviv
(4) Citizenship: Israeli
(5) Membership of Board of Directors Committees: No
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party: No
(8) Date of start of tenure as a director: November 24, 2005
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
Completed two years graduate degree studies in Economics and Social Sciences at Tel Aviv University
From November 2005 – independent adviser at Magnolia Silver Jewelry and Magnolia Export Logistics Ltd.
2001-November 2005 Chairman of the Board of Magnolia Silver Jewelry Ltd.
2003-November 2005 CEO and partner Magnolia Export Logistics Ltd.
From 2004 to the present – independent consultant to Careline-Neka
From 2000 to the present – independent consultant – strategic consultation to retail companies in Israel and abroad
2000-2002 – Strategic consultation to cosmetic companies abroad
1998-2000 – CEO and partner of NewPharm
1995-2000 – CEO and partner of April Ltd.
Director at:
2003-2005 Director in Agis
Since 2006 Director in Prigo
(10) Related to an interested party in the Corporation: No

E. (1) Name: **Stephen Grabiner*** ID. No. 024558479
(2) Date of birth: September 30, 1958
(3) Address: 15 Portland Place, London, U.K
(4) Citizenship: British
(5) Membership of Board of Directors Committees: Member of Executive Committee
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party:
The director is a Partner, Apax Partners Worldwide LLP
(8) Date of start of tenure as a director: October 11, 2005
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
MBA, Manchester University
From 1999 Partner, Apax Partners Worldwide LLP
Director at:

Apax Partners Europe Managers Ltd
Cloverhawk Ltd
ISC (International Sportsworld Communicators)
Jewish Chronicle Limited
PCM Holding B.V
Ap.Sb.Ar Holdings Ltd.
Yellow Green Finance & Investment Ltd
Purple Green Project & Investment

(10) Related to an interested party in the Corporation: No

F. (1) Name: **Isaschar (Sachi) Gerlitz** ID. No. 051741270

(2) Date of birth: April 28, 1953
(3) Address: Apax, 2 Maskit Street, Herzlyia 46120
(4) Citizenship: Israeli
(5) Membership of Board of Directors Committees: Audit Committee
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party:
The director works at Apax Partners Israel Ltd., a company advising the Apax Funds
(8) Date of start of tenure as a director: October 11, 2005
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
BSc Computer and Electrical Engineering, Tel Aviv University
Program for Business Administration for Industrial Management, Bar Ilan University
From February 2001, partner in the Apax Fund
July 1991 – Senior VP Business Development, CTO at Comverse
Director at:
Crescendo Networks
Bitband
Mobixell Network
Star Home
(10) Related to an interested party in the Corporation: No

G. (1) Name: **Yigal Cohen-Orgad*** ID. No. 7703143

(2) Date of birth: August 30, 1937
(3) Address: 9 Frenkel Street, Ramat Aviv, Tel Aviv
(5) Membership of Board of Directors Committees: Executive Committee, Audit Committee
(6) External Director: Yes
(7) Employee of the corporation, a subsidiary, related company or interested party: No
(8) Date of start of tenure as a director: January 26, 2004
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
BA Economics and Education
Chairman of the Executive Committee of the Judea and Samaria Academic College
Director at:
Israel Electric Corporation
Self-employed – Construction project manager
(10) Related to an interested party in the Corporation: No
* Director with accounting and financial expertise

H. (1) Name**: Menachem Inbar*** ID. No. 000483982

(2) Date of birth: September 3, 1948
(3) Address: 5 Hagilad Street, Ramat Gan
(4) Citizenship: Israeli
(5) Membership of Board of Directors Committees: Chairman of the Audit Committee
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party:
The director assists Moshe Arkin, who is an interested party in the Company, in managing his investments
(8) Date of start of tenure as a director: October 11, 2005
(9) Education and employment during the past five years and details of the corporations in which he serves as director:

BA Social Sciences, Bar Ilan University
Since 2000 – partner in Shipman-Inbar Ltd.
Director at:
Elrov Israel Ltd.
ITL Optronics Ltd.
Arkin Communications Ltd.
Shipman-Inbar Ltd.

(10) Related to an interested party in the Corporation: No
* Director with accounting and financial expertise

I. (1) Name: **Adam Chesnoff*** ID. No. 022113567
(2) Date of birth: November 16, 1965
(3) Address: 226S. Saltair Avenue, Los Angeles, CA 90049
(4) Citizenship: Israeli and American
(5) Membership of Board of Directors Committees: Member of the Executive Committee
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party:
The director is President and Chief Operating Officer of SCG Israel Ventures LLC, which owns 45% of the capital and 40.5% of the voting rights in Ap.Sb.Ar. Holdings Ltd. Ap.Sb.Ar. Holdings Ltd. owns 30% of the Company's share capital (which is held in trust by Romema Investments Co. Ltd)
(8) Date of start of tenure as a director: October 11, 2005
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
BA Economics and Management, Tel Aviv University
MBA, Business School, UCLA
From 1999 President and Chief Operating Officer at Saban Capital Group
Director at:
Prosieben SAT 1 Media A6 (Germany)
KSF Corp, (incorporated in Delaware)
(10) Related to an interested party in the Corporation: No
Adam Chesnoff holds 2.025% of SCG Israel Ventures Ltd.
SCG Israel Ventures LLC owns 45% of the capital and 40.5% of the voting rights in Ap.Sb.Ar. Holdings Ltd. Ap.Sb.Ar. Holdings Ltd. owns 30% of the Company's share capital (which is held in trust by Romema Investments Co. Ltd.)

J. (1) Name: **Blanche Kay** ID No. 048202717
(2) Date of birth: March 19, 1930
(3) Address: 10 Manya V'yisrael Street, Tel Aviv
(4) Citizenship: Israeli
(5) Membership of Board of Directors Committees: Member of the Audit Committee and the Security Committees
(6) External Director: Yes
(7) Employee of the corporation, a subsidiary, related company or interested party: No
(8) Date of start of tenure as a director: November 23, 2000*
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
MGr Law Degree – Hebrew University of Jerusalem
Since December 2002 – Chairwoman of Judicial Appeal Committee – District Court
Mediator in legal cases in various courts
1973-1994 - Judge (retired)
Chair of the Public Committee for Investigation of the Functioning of the Second Authority for Radio and Television
1995-1998 – Founder and President of the Israel-Jordan Chamber of Commerce, now a member of management
Director at:
2000-2003 – Director of Dead Sea Shore Development Company
From 2002- External director of Optima Enterprise & Investments
From Jan 15, 2006 – member of a public committee for determining designation of proceeds from inheritances for the benefit of the State
(10) Related to an interested party in the Corporation: No

* Except for a short break. Current term commenced on January 26, 2004.

K. (1) Name: **Kihara R. Kiari**e Passport No. 039101782
(2) Date of birth: May 16, 1974
(3) Address: 10100 Santa Monica Blvd. Los Angeles, California 90067, U.S.A.
(4) Citizenship: USA
(5) Membership of Board of Directors Committees: No
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party: The director is an officer (director) of the Saban Capital Group, a company with an indirect holding in Ap.Sb.Ar. Holdings Ltd.
(8) Date of start of tenure as a director: November 24, 2005
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
BA Economics, Dartmouth College
MBA, Harvard Business School
2003-2006 Saban Capital Group (director)
1999-2001 Associate in AEA Investors
Director at:
Saban Capital Group
(10) Related to an interested party in the Corporation: No

L. (1) Name: **Arieh Saban** ID NO. 064902083
(2) Date of birth: May 2, 1947
(3) Address: 59 Kaplan Street, Herzlyia
(4) Citizenship: Israeli
(5) Membership of Board of Directors Committees: No
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party: No
(8) Date of start of tenure as a director: October 11, 2005
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
From 2001 – partner in the Fox Kids Channel
For 15 years distributed and marketed children's television programs through Israel Audio Visual Corp.
Director at:
Keshet Broadcasting Ltd.
(10) Related to an interested party in the Corporation: Yes
The director is the brother of Haim Saban. Haim Saban is the controlling shareholder of SCG Israel Ventures LLC, which owns 45% of the capital and 40.5% of the voting rights in Ap.Sb.Ar. Holdings Ltd. Ap.Sb.Ar. Holdings Ltd. owns 30% of the Company's share capital (which is held in trust by Romema Investments Co. Ltd)

M. (1) Name: **Elon Shalev** ID No. 050705276
(2) Date of birth: July 26, 1951
(3) Address: 70 Yehoshua Bin Nun Street, Tel Aviv
(4) Citizenship: Israeli
(5) Membership of Board of Directors Committees: No
(6) External Director: No
(7) Employee of the corporation, a subsidiary, related company or interested party:
The director provides services to KSF Corp., which is a company indirectly controlled by Haim Saban who is the controlling shareholder of SCG Israel Ventures LLC, which owns 45% of the capital and 40.5% of the voting rights in Ap.Sb.Ar. Holdings Ltd. Ap.Sb.Ar. Holdings Ltd. owns 30% of the Company's share capital (which is held in trust by Romema Investments Co. Ltd)
(8) Date of start of tenure as a director: October 11, 2005
(9) Education and employment during the past five years and details of the corporations in which he serves as director:
BA Political Science, Tel Aviv University
(two years) from 2000 VP Discount Investments
Director at:

Shahal Medical Services Ltd. as well as at its subsidiaries
Loggia Ltd.
Igloo Ltd.
Keshet Broadcasting Ltd.

(10) Related to an interested party in the Corporation: No

13. Senior Officers of the Corporation

A. . (1) Name: **Yacov Gelbard** ID No. 030256622
(2) Date of birth: May 2, 1947
(3) Date of taking office: October 11, 2005
(4) Position in the Company: CEO
Position in a subsidiary of the Company or of an interested party of the Company:
Director at:
Pelephone Communications Ltd.
Bezeq International Ltd.
BezeqCall Ltd.
D.B.S. Satellite Services (1998) Ltd.
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
BA Economics and Accounting, Tel Aviv University, qualified CPA
2001-2005 CEO Pelephone Communications Ltd.
1999-2001 CEO XXL Electronic Trading, Discount Investments

B. (1) Name: **Yitzhak (Ika) Abravanel** ID No. 52626827
(2) Date of birth: June 29, 1954
(3) Date of taking office: November 16, 2005
(4) Position in the Company: Deputy CEO for fixed-line communication
Position in a subsidiary of the Company or of an interested party of the Company:
Director at:
Pelephone Communications Ltd.
Bezeq International Ltd.
BezeqCall Ltd.
Bezeq Online Ltd.
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
BA Political Science, Haifa University
MA Political Science, Haifa University
Graduate of the National Security College
2001-Senior VP of Operations and Customer Service, Pelephone Communications Ltd.

C. (1) Name: **Ron Eilon** ID No. 59211722
(2) Date of birth: May 27, 1965
(3) Date of taking office: Since March 2, 2003, has served as CFO and since November 16, 2005, as Deputy CEO and CFO
(4) Position in the Company: Deputy CEO and CFO
Position in a subsidiary of the Company or of an interested party of the Company:
Director at:
Pelephone Communications Ltd.
Bezeq International Ltd.
Bezeq Online Ltd (Chairman)
D.B.S. Satellite Services (1998) Ltd.
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
BA Economics
MBA Finance
Outside director in Otsarit
1999-2003 CFO at MIRS, Motorola

1996-1999 The deputy in charge of budgets, Ministry Of Finance
2003-2005 CFO, Bezeq
As of 10/2005 Mr. Ron Eilon serves as Deputy CEO AND CFO

D. (1) Name: **Bosmat Chelouche** ID No. 052592664
(2) Date of birth: May 8, 1954
(3) Date of taking office: Since September 1, 1998, general counsel, and since November 16, 2005 also VP and Corporate Secretary
(4) Position in the Company: VP, General Counsel and Corporate Secretary
Position in a subsidiary of the Company or of an interested party of the Company:
Member of the Board at:
Pelephone Communications Ltd.
BezeqCall Ltd.
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
LLC, Tel Aviv University
1998-2005 Bezeq General Counsel

E. (1) Name: **Ehud Mezuman** ID No. 052176336
(2) Date of birth: February 17, 1954
(3) Date of taking office: July 21, 2005
(4) Position in the Company: Deputy VP Management Resources
Position in a subsidiary of the Company or of an interested party of the Company: No
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
Three years at Tel Aviv University – Social Sciences (without graduating)
From 2001 Head of the Manager Development Department at Bezeq

F. (1) Name: **Michel Hibert** ID No. 068200203
(2) Date of birth: October 26, 1956
(3) Date of taking office: August 12, 2004
(4) Position in the Company: Deputy VP Engineering and Planning
Position in a subsidiary of the Company or of an interested party of the Company: No
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
BA Electronic Engineering, Ben Gurion University
EMBA Strategy, Hebrew University of Jerusalem
2003-2004– Manager of Access Networks Engineering Department, Engineering and Planning Division, Bezeq
1998-2003– Manager of Access Networks Department, Engineering and Planning Division, Bezeq

G. (1) Name: **Raz Heiferman** ID No. 67614339
(2) Date of birth: January 25, 1949
(3) Date of taking office: March 16, 1997
(4) Position in the Company: VP Information Technology
Position in a Subsidiary of the Company or of an interested party of the Company: No
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
BA Economics and Statistics
MBA.
1992-1997-1997 – Contahal Ltd. Last position – Manager of Technology and Software Engineering Division

H. (1) Name: **Danny Oz** ID No. 054299953
(2) Date of birth: June 16, 1956
(3) Date of taking office: September 1, 1998
(4) Position in the Company: Controller and Deputy CFO

Position in a subsidiary of the Company or of an interested party of the Company: No
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
BA Economics and Accounting, Hebrew University of Jerusalem. Licensed CPA
EMBA Integrative Management, Hebrew University of Jerusalem
Since September 1998 – Company Controller

I. (1) Name: **Danny Friedman** ID No. 014684385
(2) Date of birth: September 17, 1959
(3) Date of taking office: December 18, 2003
(4) Position in the Company: Internal Auditor
Position in a subsidiary of the Company or of an interested party of the Company: No
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
BA Accounting, Hebrew University of Jerusalem
BA Economics and Statistics, Hebrew University of Jerusalem
CIA – Certified Internal Auditor (USA)
CISA – Certified Information Systems Auditor (USA)
1987-2003 – Chief Auditor, Finance at Bezeq

J. (1) Name: **Erez Hasdai** ID No. 022760599
(2) Date of birth: May 21, 1967
(3) Date of taking office: November 16, 2005
(4) Position in the Company: Deputy VP Economics
Position in a subsidiary of the Company or of an interested party of the Company: No
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
BA Economics, Tel Aviv University
MBA, Florida International University
Since July 27, 2000 – Manager, Strategic Planning Department
From August 1, 2003 to February 1, 2004 – Deputy VP Economics

K. (1) Name: **Ran Guron** ID No. 024113268
(2) Date of birth: December 25, 1968
(3) Date of taking office: January 9, 2006
(4) Position in the Company: VP Marketing
Position in a subsidiary of the Company or of an interested party of the Company: No
(5) Related to a senior officer or to any interested party: No
(6) Education and business experience over the past five years:
BA Economics, Hebrew University of Jerusalem
MBA, Hebrew University of Jerusalem
2003-2005 VP Marketing, Barak
1997-2002 Marketing Manager, Business Sector, Cellcom

Note: The list of senior officers above includes the office holders according to the definition of “holder of a senior position” in the Securities Regulations (Periodic and immediate reports), 5730-1970. The office holders who do not fall within that definition but are included in the definition of an officer in the Companies Law, 5759-1999, are not included in the above list (even though they report directly to the CEO), and they are: managers of operations divisions and the Company Spokesperson.

14. The Auditors of the Corporation

Somech Chaikin – Certified Public Accountants (Isr.)
Address: 17 Ha’Arba’a Street
Millenium Tower KPMG
Tel Aviv 64739
Tel: 03-6848000

15. Change in the Memorandum or Articles of Association

On April 6, 2005 the General Meeting approved the amendment to the Company's Articles of Association, so that the wording of Regulation 225(C)(2) will be deleted and will be replaced by:

"Another person received approval for control of the Company in accordance with the Telecommunications Law and the Telecommunications Order, granted to him in writing and in advance, and he controls the Company, whether alone or whether with others, including with the State in accordance with the agreement with it."

16. Recommendations and Resolutions of the Directors Before the General Meeting and their Resolutions which are not Subject to the Approval of the General Meeting

16.1 Payment of a dividend

On March 1, 2006, the Board of Directors decided to recommend to the General Meeting of the Shareholders of the Company the distribution of a cash dividend to the shareholders of the Company, in a total amount of NIS 1,200,000,193 which constitute, as at the date of the distribution, NIS 0.4606446 per share and 46.06446% of the issued and paid up capital of the Company. According to the decision: The rate of the dividend actually paid shall be determined according to the Company's issued and paid up share capital at the end of the business day of the 2nd of April 2006 ("The Determining date"), the dividend will be paid to the shareholders of the Company who are registered in the Company's shareholders register at the end of the Determining date, The "X" date shall be on the 3rd of April 2006 and the payment date will be on the 16th of April 2006. The said dividend shall be deducted of tax at source in accordance with the provisions of the law.

16.2 Changes in the Articles

Replacement of Article 225(C)(2) with the following wording: "Another person received approval for control of the Company in accordance with the Telecommunications Law and the Telecommunications Order, granted to him in writing and in advance, and he controls the Company, whether alone or whether with others, including with the State in accordance with the agreement with it".

17. Resolutions of a Special General Meeting

Appointment of Rachel Kremerman-Meridor as director (resolution from March 1, 2005)

The general meeting approved the appointment of Rachel Kremerman-Meridor as director in the Company.

Approval for remuneration for the Chairperson of the Board (resolution from March 1, 2005)

The Meeting approved a one-time personal remuneration for 2004 for the Chairwoman of the Board, Adv. Miriam Mazar, in the amount of 1.2 salaries (approximately NIS 49,400), as part of the one time personal remuneration for 2004 for senior employees employed under personal agreements (new version).

Election of directors (resolution from March 22, 2005):

The General Meeting approved the appointment of candidates Rami Nomkin and Yehuda Porat as directors in the Company.

Indemnity for directors and officers for the sale of the core control (resolution from April 6, 2005)

The General Meeting approved the Company making a commitment to indemnify for any financial liability imposed on officers in the Company and for reasonable legal expenses they incur, related directly or indirectly to the process of sale of the State's holdings in the Company by way of a private sale of 30% of the Company's share capital and options for the purchase of additional 10.66% of the Company's share capital, in accordance with the decision of the Ministerial Committee for Privatization on July 19, 2004, Number MH/17, in accordance with the terms specified in the notice of commitment to indemnify an officer, which was attached to the Immediate Report of the Company dated March 14, 2005.

The commitment to indemnify will be given to officers who served and/or were appointed and/or will be appointed in the Company as of the start of the Company's preparations for the sale process (the date of publication of the notice for the sale of the core control – August 27, 2004) and until the date of completion of the sale process.

The total amount of the indemnity will not exceed 25% of the Company's share capital (according to its financial statements for 2004, linked to the Consumer Price Index of November 2004), including for the commitment to indemnify in advance given up to the date of issue of the notice of indemnification together with the commitment to indemnify in advance in accordance with the Minister of Finance's letter from April 21, 2004, which will be given, if given, on the eve of the transfer of core control in the Company by the State (a commitment that was approved at the General Meeting on May 16, 2005, as described below).

Amendment of Article 225(C)(2) to the Company's Articles (Resolution from April 6, 2005)

On April 6, 2005 the General Meeting approved an amendment to the Company's Articles so that the wording of Article 225(C)(2) will be deleted and will be replaced by:

"Another person received approval for control of the Company in accordance with the Telecommunications Law and the Telecommunications Order, granted to him in writing and in advance, and he controls the Company, whether alone or whether with others, including with the State in accordance with the agreement with it".

Approval of severance pay for the Chairwoman of the Board – Adv. Miriam Mazar (resolution from April 6, 2005).

The General Meeting approved severance pay of 100% more than is prescribed in the law, in the amount of NIS 99,000, to the outgoing Chairwoman of the Board, Adv. Miriam (Miki) Mazar.

Approval to exercise an option for the purchase of a run off policy for the liability of Company officers (Resolution from May 16, 2005)

The General Meeting approved exercise of an option by the Company for the purchase of a run off officers liability policy for the Company's officers, under the policy terms that were in effect from July 31, 2004 to July 30, 2005, with the following changes:

A. The period of insurance – seven years from the date of closing the transfer of the State's shares in the sale process carried out in accordance with the decision of the Ministerial Committee for Privatization of July 19, 2004, No. MH/17 (hereinafter: "the **Date of Closing the Sale**").

B. The total amount of the insurance cover will not exceed $150,000,000, plus $30 million for legal expenses in Israel only.

C. Limits of liability:

   1) Cover for the first three years – within the limits of liability of $150,000,000 plus $30 million for legal expenses in Israel only.

   2) Cover for three additional years – within the limits of liability of $75,000,000 plus $15 million for legal expenses in Israel only.

   3) Cover for the seventh year – within the limits of liability of $25,000,000 plus $5 million for legal expenses in Israel only.

   It is clarified that there is one limit of liability for the entire run-off period.

D. The amount of the premium for the entire period of insurance – $3,000,000 (in one advance payment).

Approval of an undertaking to indemnify officers in the Company (resolution from May 16, 2005)

The General Meeting approved a commitment by the Company, given in advance to officers in the company, who were serving in the company at the time the commitment was made, in respect of indemnity that would apply on the Date of Closing the Sale or who were in office during the seven years preceding the Date of Closing the Sale, to indemnify them for financial liability imposed on him in each of the events specified in the document attached to the notice of indemnity, in which the officer acted in good faith and had reasonable grounds to assume that the action was in the best interests of the Company. The indemnity will be granted under the terms set out in the notice of commitment to indemnify.

It is hereby clarified that the Company's commitment to indemnify will not apply to an event for which the insurer has accepted liability under an insurance policy, including the aforesaid. However, if the officer was charged, due to an indemnifiable event, an amount in excess of the amount paid to him by the insurer, the company will indemnify him with the difference, subject to the amount of indemnity for all officers in the company as defined above, not exceeding $150,000,000 plus $30 million for legal expenses in Israel only per claim and in total for every year of insurance during the period of insurance as defined above.

Approval of transactions between the Company and the Ministry of Defense (Resolution from June 2, 2005)

1. The General Meeting resolved to remove from the agenda approval of the agreement for the provision of communication services by the Company to the IDF.
2. To approve the settlement agreement between the Company and the Ministry of Defense concerning the Company's claim in respect of the deduction of discounts at a rate of 18% on various charges included under the item Miscellaneous in the IDF's telephone bills.

Election of directors (resolution from June 2, 2005):

The General Meeting approved the candidates proposed by Goren Capital Group Ltd. to serve as directors in the Company:

Chanoch Barkat, Pinchas Buchris, Haim Saban, Adam Chesnoff, Elon Shalev, Moshe Arkin, Menachem Inbar.

The appointment of the above candidates was approved subject to closing the transfer of the State's holdings to the purchaser of the State's holdings, as described in the notice pursuant to Section 37 of the Securities Law, 5728-1968, dated May 9, 2005 and subject to receipt of approval of the General Security Service that 75% of the directors in the Company have an appropriate security clearance, in accordance with the Telecommunication Order (Determination of an essential service provided by “Bezeq”, The Israeli Telecommunication Corp. Ltd.), 5747-1997.

Election of directors (resolution from June 22, 2005):

The General Meeting approved the appointment of the candidates listed below to serve as directors in the Company:

Stephen Grabiner, Arieh Saban, Issachar (Sachi) Gerlitz

The appointment of the above candidates was approved subject to closing the transfer of the State's holdings to the purchaser of the State's holdings, as described in the notice pursuant to Section 37 of the Securities Law, 5728-1968, dated May 9, 2005 and subject to receipt of approval of the General Security Service that 75% of the directors in the Company have an appropriate security clearance, in accordance with the Telecommunication Order (Determination of an essential service provided by Bezeq, The Israeli Telecommunication Corp. Ltd.), 5747-1997.

Extension of the officers insurance policy including the run off for a period of up to four months (Resolution from August 3, 2005)

The General Meeting approved the extension of the officers insurance policy, including the run off option, for a period of up to four months, in accordance with the terms specified in the appendices attached to the resolution and at a cost of $112,500 per month.

Approval of a commitment with Clal Insurance Co. Ltd. for the purchase of a policy to ensure the liability of officers in the Company and approval of the Framework Agreement for two additional years for a contractual agreement for future insurance policies (decision from November 24, 2005)

The Board of Directors approved a commitment with Clal Insurance Co. Ltd. for the purchase of an officers liability policy for Company officers for one year from October 11, 2005, with a limit of liability of a $150 million per claim and in total for the entire year of insurance. In addition $30 million per claim and for all claims for the period of insurance for legal expenses in Israel only. The limit of liability for subsidiaries – $50 million (as part of the aforesaid limit of liability). Annual premium – $675,000 plus 1.5% stamp duty.

The Board also approved a Framework Agreement in effect from the date of receiving the approval of the General Meeting until two years after the expiration of the current policy, for the Company to contract in the normal course of business in future insurance policies, in effect (after expiration of the current policy as specified above) to cover the liability of directors and officers as may be from time to time, including directors and officers who are or are likely to be considered as controlling shareholders in the Company – by way of a Framework Agreement as defined in the Companies Regulations (Benefits in transactions with interested parties), 5760-2000, at an annual premium of US$ 675,000, plus an amount constituting up to 20% of that premium in respect of the amount of the existing insurance cover (as specified above) as well as $30 million per claim and for all the claims for the period of insurance for legal expenses in Israel only. The limit of liability for subsidiaries – $50 million (as part of the aforesaid limit of liability).

If a sum of insurance cover is purchased that differs from any of the existing sums of insurance, the premium can be increased up to a ceiling of 20% of the amount of the premium of the current policy (US$ 675,000), i.e. the maximum premium (after the increase) will in any case not exceed US$ 810,000.

18. Transactions Requiring Special Approvals

Receipt of a loan for the purpose of investing in DBS (resolution from January 20, 2005):

The Company will take a loan from a institutional body in the amount of NIS 15 million (with an option to the lender to lend the Company an additional NIS 15 million within one year from the date of the loan). The Company will invest the loan in DBS, as part of the Company's shareholders' loans to DBS.

Undertaking in respect of a loan from an institutional body to DBS (resolution from February 17, 2005):

A commitment by the Company to repay the loan extended by an institutional body to DBS in the amount of NIS 15 million (with an option of an additional NIS 15 million). The commitment is contingent upon the occurrence of certain events, given a positive value of DBS according to a pre-determined formula. Performance of the transaction is subject to the execution of final agreements on the matter.

This resolution supersedes the resolution from January 20, 2005 set out above.

Undertaking in respect of a loan from two institutional bodies to DBS (resolution from April 14, 2005):

A commitment by the Company to repay the loan extended by two institutional bodies to DBS in the amount of NIS 35 million (with an option of an additional NIS 35 million). The commitment is contingent upon the occurrence of certain events, given a positive value of DBS according to a pre-determined formula (these are two separate loans, one in the amount of NIS 15 million and the second in the amount of NIS 20 million, with options in those same amounts).

19. Valid Insurances and Indemnities

The Company has an officers liability insurance policy. The insurance ceiling is 150 million dollars per event and for the period (twelve months), plus up to 30 million dollars for legal expenses in Israel.

During 2005 the Company purchased policies to insure the liability of officers, and commitments were made to indemnify directors and officers, as detailed below:

1. A commitment to indemnify for any financial liability imposed on officers in the Company and for reasonable legal expenses they incur, related directly or indirectly to the process of sale of the State's holdings in the Company – See Section 17 above.
2. A commitment to indemnify officers who served during the seven years preceding the Date of Closing the Sale in the Company – See Section 17 above.
3. Exercise of an option to purchase a run off insurance policy to insure the liability of Company officers – See Section 17 above.
4. Extension of the officers liability insurance policy, including the run off option, for a period of up to four months – See Section 17 above.

It should be noted that in the past, the Company granted indemnity to officers in the following areas:

A. A letter of indemnity in respect of the issuance under a prospectus from 1998.

B. A letter of indemnity for a draft of the prospectus which was submitted to the Securities Authority in 1999.

C. A letter of indemnity for Y2K risks.

D. A letter of indemnity in respect of an allotment of shares, in everything relating to the framework agreement from January 13, 2002.

E. An advance commitment of indemnity for any expense or financial liability which is imposed on an officer following a proceeding filed against him in respect of the Company's prospectus from May 2004.

F. An advance commitment to indemnify Company officers who served in the Company at the time the commitment to indemnify was made or who were in office during the seven years preceding that date, for any expense or financial liability imposed on an officer due to a claim by a shareholder who held, at any time during the fours years preceding the date on which the commitment to indemnify was given, 15% and more of the issued share capital of the Company.

G. A commitment to Company officers who served in the Company at the time a commitment was made in respect of indemnity or who were in office during the seven years preceding that date, to grant a loan for financing reasonable litigation expenses in a proceeding in which an officer is sued by another person, including a derivative action. The loan will become a grant if a competent court does not impose liability on the officer in a peremptory decision.

H. A commitment to officers that the insurance cover for events covered by an officers insurance policy, which the Company purchased in July 2003, will be maintained for seven years, provided that the cost of the insurance premium is reasonable.

Date

"Bezeq" The Israel Telecommunication Corp. Limited

Name and title of signatories:

Moshe Arkin, Chairman of the Board
Yacov Gelbard, CEO